



Aggressive Actions Need Immediate Response to Meet Objectives of the CFO Act



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Comptroller General
of the United States

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To the President of the Senate and the
Speaker of the House of Representatives

Financial Audit:
Aggressive Actions
Needed for Air Force
to Meet Objectives
of the CFO Act

This report presents the results of our review of the Air Force's financial management operations for fiscal year 1989 and Department of Defense (DOD) efforts to correct deficiencies presented in our report entitled, Financial Audit: Air Force Does Not Effectively Account for Billions of Dollars of Resources (GAO/AFMD-90-23, February 23, 1990). This current report confirms the severity and extent of Air Force financial management deficiencies reported in February 1990 and summarizes the information previously discussed in 10 other reports issued to Air Force organizations during our 1989 review.

We are sending copies of this report to the Secretaries of Defense and the Air Force, the Director of the Office of Management and Budget, interested congressional committees, and other interested parties. Copies will also be made available on request.

This report was prepared under the direction of David M. Connor, Director, Defense Financial Audits, who may be reached on (202) 275-7095, if you or your staff have any questions.

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Comptroller General
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Executive Summary

Purpose

The U.S. Air Force was the first military service that attempted to develop consolidated financial statements of sufficient accuracy and reliability to be considered auditable. GAO's February 1990 report entitled, Financial Audit: Air Force Does Not Effectively Account for Billions of Dollars of Resources (GAO/AFMD-90-23), discussed weaknesses in the Air Force's accounting systems, procedures, practices, and controls that prevented GAO from expressing an opinion on those financial statements for fiscal year 1988.

Although the Air Force decided not to prepare consolidated financial statements for fiscal year 1989, GAO evaluated the Air Force's financial operations and financial reports submitted to the Department of the Treasury for that year. This included assessing (1) the effectiveness of significant internal accounting controls, (2) the accuracy and propriety of transactions and account balances, and (3) the reliability of the year-end annual financial reports provided to the Department of the Treasury. Since issuing its February 1990 report, GAO has issued 10 additional reports to various Air Force organizations detailing problems and deficiencies identified during both its fiscal year 1988 and 1989 audits and suggesting appropriate corrective actions. This report summarizes the information GAO previously discussed in these 10 reports. It also discusses the progress the Air Force and the Department of Defense (DOD) have made in implementing the recommendations in GAO's February 1990 report.

This report also identifies actions the Air Force and DOD need to take to meet the objectives of the Chief Financial Officers Act of 1990 (Public Law 101-576) to prepare accurate and reliable consolidated Air Force financial statements for fiscal year 1992 and have them successfully audited.

Background

The Air Force is a huge organization by any measure. It employs about 900,000 military and civilian personnel at over 130 bases worldwide in defense of the United States and its allies. It controls assets which were reportedly valued at \$325 billion as of September 30, 1989, and annually receives over \$90 billion in appropriated funds. The Air Force conducts its mission through the development, deployment, and operation of complex, highly sophisticated equipment, including tactical and strategic aircraft, missiles, and satellites.

Clearly, any organization of this size, complexity, and importance needs effective financial management systems, procedures, and practices to

(1) control its vast operations, (2) provide financial accountability over assets and safeguards against fraud, waste, and abuse, and (3) report on the financial stewardship and performance of its managers. GAO's February 1990 report showed that the Air Force had not achieved these basic financial management objectives. That and subsequent GAO reports provided 92 recommendations and suggestions for dealing with financial management deficiencies. This report follows up on the conditions noted in GAO's February 1990 report and provides further information on their causes, extensiveness, and impact upon financial information used and reported by the Air Force.

Results in Brief

As of January 1991, when GAO conducted follow-up work on the status of corrective actions in response to its February 1990 report, the Air Force and DOD had made only limited progress in implementing previous GAO recommendations. DOD's response to that report indicates that it is primarily relying on long-term initiatives to solve the problems identified by GAO. GAO's 1989 audit, however, gives further evidence of the need for DOD and the Air Force to take more action in the short term to overcome the identified problems. This is necessary in order to meet the objectives of the Chief Financial Officers Act and to provide DOD and Air Force management with more reliable information to better manage and control Air Force resources now. In today's environment of decreasing budgets and restructuring of defense priorities and programs, DOD needs more reliable financial data than provided by Air Force systems.

The Air Force's accounting systems generated unreliable and inaccurate financial information which was of little value for either internal management purposes or external reporting. Billions of dollars of budgetary outlays were not accurately recorded in the accounting system because budgeting and accounting systems are not integrated. GAO also identified billions of dollars of adjustments which were needed to correct errors in and improve the accuracy of the Air Force's fiscal year 1989 Treasury financial reports and underlying records. After GAO advised the Air Force of the magnitude of errors in its annual financial reports, officials recalled the reports and made about \$62 billion in corrections. Additionally, the reported valuations of the Air Force's weapons systems (aircraft and missiles) were materially misstated because the Air Force does not value these assets at actual costs.

The Air Force's inventory systems did not correctly report either the quantities or values of high-dollar investment item inventories at the Air Logistics Centers. GAO's physical counts of investment items at four Air

Logistics Centers disclosed that a large percentage of inventory records differed from quantities actually on-hand. GAO estimated that several billion dollars of errors existed in the inventory accounts at those locations. Also, GAO found that deficiencies in stock fund operations reduced incentives for good inventory management and contributed to sharply increased prices in recent years. The deficiencies GAO identified result in substantial unnecessary costs to the Air Force and require immediate consideration by management.

GAO found that the Air Force's system of internal controls did not adequately safeguard all assets nor ensure that account balances and financial reports were reliable. GAO also found that the Air Force did not report material internal control weaknesses to DOD as required by the Federal Managers' Financial Integrity Act of 1982.

Principal Findings

Accounting System Produces Inaccurate and Unreliable Data

The Air Force's general funds general ledger, a subsystem of the General Accounting and Finance System, should serve as the basis for financial reports. However, as shown in GAO's previous review and further discussed in this report, the system produces inaccurate and unreliable financial information that cannot be relied upon to manage, monitor, and evaluate operations. The Air Force's accounting and financial management systems are not integrated under a departmentwide, transaction-driven general ledger. Generally, budgetary transactions, such as obligations and expenditures, are recorded in the budgetary subsystem of the General Accounting and Finance System. Such transactions also need to be recognized in the expense, asset, and liability accounts in the general ledger subsystem. However, GAO found that the effects of budgetary transactions were not consistently and accurately recognized in the general ledger accounts. GAO estimated that, in fiscal year 1989, approximately \$20 billion of budgetary expenditures for capital assets were not accurately recorded or could not be traced to accounts in the general ledger subsystem.

Billions of Dollars of Errors Identified in Annual Treasury Financial Reports

In auditing the Air Force's annual financial reports, which are required by the Department of the Treasury, GAO identified billions of dollars of adjustments needed to improve the accuracy of the reports and the underlying records. During July 1990, GAO proposed over \$116 billion of adjustments to these reports. The net effect of these adjustments would have been to decrease assets by \$50.4 billion, liabilities by \$1.4 billion, revenues by \$8.0 billion, and expenses by \$10.6 billion. After GAO informed the Air Force of the magnitude of the errors, officials recalled the reports, made approximately \$62 billion of corrections, and submitted the revised reports to the Department of the Treasury. It did not record \$57 billion in adjustments primarily to recognize depreciation on general fund assets. Generally accepted accounting principles for federal agencies encourage, but do not require, agencies to depreciate these assets to provide more accurate information on the costs of operations. Depreciation has governmentwide significance because some agencies record depreciation on general fund assets while others do not. The recently established Federal Accounting Standards Advisory Board will address issues such as depreciation accounting and recommend accounting standards for federal entities.

More Reliable Costs of Weapons Systems Can Be Compiled

As previously discussed in GAO's February 1990 report, the Air Force does not report the value of its weapons systems, such as aircraft and missiles, at actual cost. Instead, it uses "unit costs," which often deviate substantially from actual costs and do not include the value of government-furnished materials. Air Force officials stated that these unit costs were "initial fly-away costs"—the estimated average costs at the time the contractor delivered the first aircraft or missile. This practice does not comply with DOD Accounting Manual standards which require that such assets be reported at actual costs. During fiscal year 1989, the Air Force spent about \$11 billion to acquire and modify aircraft and missiles. While these expenditures were reported by the fund control system, the expenditures did not accurately update weapons systems costs in the general ledger.

Until an improved cost accounting system for weapons systems is available, the Air Force could develop and maintain more accurate valuations for its weapons systems by extracting data from its fund control system. Most recent Air Force procurement expenditures have been for relatively few systems. Cost data for these systems are readily available from the fund control system. Compiling more accurate and complete costs for the new weapons systems, including costs of government-furnished material, would improve the reliability of Air Force weapons

systems account balances. Values for older systems could be established by appraisal or other reasonable means.

Accounting and Internal Controls Over Air Logistics Inventories Are Not Adequate

Weaknesses in inventory management and controls result in substantial unnecessary costs to the Air Force. The internal control weaknesses and management deficiencies have undoubtedly contributed to the \$11 billion of unrequired inventory reported by Air Force as of September 30, 1990.

The Air Force's inventory records and accounts do not accurately portray either the quantities or the values of investment item inventories at the Air Logistics Centers. As of September 30, 1989, the Air Force reported about \$64 billion in inventory, of which about \$20 billion was high-dollar investment items and about \$6.2 billion was for lower cost stock fund items of the Systems Support Division, Air Force Stock Fund, located at the five Air Logistics Centers. GAO's physical counts of investment items at four Air Logistics Centers found that an estimated 18.3 percent of the perpetual records differed from quantities actually in storage. GAO estimated that investment item inventories valued at \$14.8 billion were overstated by \$1.5 billion in certain accounts and understated by \$0.8 billion in others. Also, GAO found that all five Air Logistics Centers made billions of dollars in automated inventory adjustments to arbitrarily force general ledger accounts into balance with perpetual inventory records. In spite of the billions of dollars involved, the Air Logistics Centers were not determining the causes for the large differences between balances in the general ledger and perpetual inventory systems, thus substantially increasing the risk of entering erroneous transactions into the general ledgers.

GAO found that the Air Logistics Centers' inventory records were unreliable because (1) errors were made when recording transactions in perpetual inventory systems, (2) computer programming errors resulted in duplicate reporting of inventories, (3) internal controls designed to prevent, identify, and detect errors were not operating as intended, (4) unserviceable and obsolete inventories were valued the same as new items, and (5) inaccurate values were assigned to many investment items as a result of not following Air Force pricing policies.

GAO found that some high-dollar inventory errors were uncorrected because the results of physical inventories were simply ignored or "cancelled" rather than processed as inventory adjustments. Ogden Air Logistics Center staff informed GAO that cancellations were sometimes

used to avoid making, and having to report to management, a high-dollar inventory adjustment. This practice circumvents established internal control procedures and is a violation of Air Force Logistics Command policy.

For stock fund inventories, GAO identified deficiencies that have reduced incentives for good inventory management and contributed to sharply increased prices in recent years by the Systems Support Division to cover operating losses. GAO estimated that the Systems Support Division lost from \$30 million to \$60 million in revenues in fiscal year 1989 due to billing problems. Further, GAO's comparison of fiscal year 1989 sales to the year-end inventory balance indicated that the Systems Support Division had about 7 years of inventory on hand, which GAO believes to be excessive. In fiscal year 1989, GAO identified at least \$278 million of errors in the Systems Support Division year-end account balances.

The stock fund problems GAO found have implications for DOD's Defense Business Operations Fund, a revolving fund to eventually finance virtually all support activities in the Department. DOD does not currently have reliable financial systems in place to operate the fund as an effective and efficient business-type entity.

**Internal Control
Weaknesses Merit
Management's Attention**

The Air Force's system of internal controls was not adequate to safeguard all assets or to ensure the reliability and accuracy of account balances and financial reports. Additionally, the Air Force's report to DOD prepared pursuant to the Federal Managers' Financial Integrity Act of 1982 did not include material internal control weaknesses identified by GAO which, in its opinion, should have been reported.

GAO found that (1) Air Force organizations did not review and analyze their account balances to ensure that they were reasonably correct, (2) reconciliations of control accounts with subsidiary accounts and supporting records were not always conducted, (3) erroneous entries and arbitrary adjustments were recorded in accounts to force them into agreement, and (4) transactions were not always recorded in a timely manner. Also, GAO noted that controls over \$592 million of direct materials at the depot maintenance centers did not ensure that materials were charged to the correct jobs or limited to actual job requirements.

Meeting the Objectives of the CFO Act Necessitates Immediate Action

The Chief Financial Officers Act of 1990 requires the Air Force to prepare consolidated financial statements for fiscal year 1992 and have them audited. Producing accurate and reliable statements that can be successfully audited will require the Air Force and DOD to take more aggressive, immediate actions to deal with the problems presented in this and previous reports. Standardized systems resulting from DOD's Corporate Information Management initiative are not expected to be implemented and operating until possibly 8 to 10 years from now. Therefore, without aggressive short-term actions, the Air Force cannot produce auditable financial statements.

Recommendations

In commenting on GAO's February 1990 report, the DOD Comptroller concurred or partially concurred with all of the 26 recommendations. However, few substantive improvements have been achieved. This is because until recently, DOD's emphasis has been on long-term efforts to improve and standardize its financial management operations, but the benefits from these efforts will not be realized for years. In the interim, the Air Force needs to improve its basic internal controls and financial information to (1) effectively perform financial management, (2) prepare auditable financial statements, and (3) facilitate congressional oversight of its programs and operations. Further, the deficiencies must be resolved before any financial management system can be effective and the Air Force can fulfill the objectives of the Chief Financial Officers Act.

Therefore, GAO reaffirms the recommendations made in its February 1990 report and the recommendations and suggestions contained in the reports issued to the Air Force during the fiscal year 1989 audit. GAO is making additional recommendations to improve management's accountability, internal controls, and the quality of financial information reported by the Air Force and to assist the Air Force in meeting the objectives of the Chief Financial Officers Act.

Agency Comments

DOD generally concurred with GAO's findings and recommendations. (See appendix IV for excerpts of DOD's comments.) In commenting on a draft of this report, DOD stated that considerable progress has been made toward improving the Air Force's general ledger accounting and the accuracy of Air Force financial reports. DOD stated that actions have been taken or are planned to address internal control weaknesses and inaccurate financial reporting problems discussed in this report.

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Abbreviations

AFAA	Air Force Audit Agency
AFAFC	Air Force Accounting and Finance Center
AFLC	Air Force Logistics Command
AFSC	Air Force Systems Command
AICPA	American Institute of Certified Public Accountants
ALC	Air Logistic Center
AVISURS	Aerospace Vehicle Inventory Status Utilization Reporting System
BLARS	Base Level Accounting and Reporting System
BPAC	Budget Program Activity Code
CBO	Congressional Budget Office
CEMS	Comprehensive Engine Management System
CFO	Chief Financial Officer
CIM	Corporate Information Management
DBOF	Defense Business Operations Fund
DFAS	Defense Finance and Accounting Service
DMR	Defense Management Review
DOD	Department of Defense
FMFIA	Federal Managers' Financial Integrity Act of 1982
GAFS	General Accounting and Finance System
GAGAS	generally accepted government auditing standards
GAO	General Accounting Office
OMB	Office of Management and Budget
SSD	Systems Support Division
TFM	Treasury Financial Manual
TFS	Treasury Financial Statements

Introduction

In the current environment of tight budgetary constraints and pending force reductions, the Department of the Air Force, one of the largest government agencies, faces an enormous challenge in effectively managing its fiscal operations. Created in 1947, the Air Force is responsible for preparing aerospace forces to perform offensive and defensive operations with the purpose of defending the United States, deterring aggression, and being ready to conduct warfare in conjunction with the other armed forces. To fulfill this mission, the Air Force receives about \$90 billion in appropriations annually and controls assets valued at a reported \$325 billion.

The Air Force employs about 900,000 civilian and military personnel and operates over 130 bases throughout the world, representing about 19 percent of the reported value of the real property held by the federal government. In addition to these facilities, the Air Force manages a reported \$97 billion of weapons systems (aircraft and missiles) and a reported \$64 billion of supplies and spare parts inventories. These comprise approximately 19 percent of the equipment and 28 percent of the inventories reported to be held by the U.S. government. In fiscal year 1989, the Air Force incurred net cash outlays of approximately \$95 billion in general funds, about 8 percent of total federal expenditures.

For fiscal year 1988, the Air Force prepared its first set of consolidated financial statements as required by generally accepted accounting principles for federal agencies and provided them to us for audit. In February 1990, we issued our report¹ on the results of our audit of those statements. We reported that (1) the Air Force lacked an effective general ledger system, (2) many assets, such as aircraft, missiles, and engines, were undervalued, (3) inventory systems did not provide accurate data, and (4) significant internal control weaknesses were found throughout the organization. As a result of these deficiencies, we could not validate the costs of over 70 percent of the assets on the Air Force's consolidated statement of financial position. We concluded that the accounts were unauditible and we were unable to express an opinion on the financial statements.

¹Financial Audit: Air Force Does Not Effectively Account for Billions of Dollars of Resources (GAO/AFMD-90-23, February 23, 1990).

Chief Financial Officers Act of 1990 Requires Financial Statement Audits

Concerned with the state of financial management systems and operations within the federal government, in November 1990, the Congress passed and the President signed into law the Chief Financial Officers (CFO) Act of 1990 (Public Law 101-576). This law is expected to have an unprecedented impact upon the federal government's financial operations. The purposes of the act are to

- enhance general and financial management practices in the federal government;
- improve financial management, accounting systems, and internal controls to (1) ensure reliable financial information and (2) deter fraud, waste, and abuse of government resources; and
- provide reliable, timely, and accurate financial information to the executive branch and the Congress in the financing, management, and evaluation of the federal government.

In accordance with the CFO Act, the President is required to appoint a CFO for each of 23 major departments and agencies, including the Department of Defense (DOD). The CFO will be responsible for developing and maintaining an integrated agency accounting and financial management system. Also, the law requires the annual preparation and audit of financial statements for federal revolving and trust funds and, to the extent practicable, for all commercial activities. On a pilot basis, agency-wide financial statements for 10 major departments and agencies, including the Air Force, are to be prepared and audited. By June 30, 1993, the Office of Management and Budget (OMB) is to report to the Congress the results of the pilot program, focusing on its benefits as well as its costs.

Under the CFO Act, the Air Force is required to prepare agencywide financial statements for fiscal year 1992. The CFO Act requires the DOD Inspector General or an independent auditor, as determined by the Inspector General, to report on an audit of the consolidated financial statements by June 30, 1993. That report will assess the accuracy and reliability of the financial statements and thus provide top management and the Congress with a better decision-making tool.

DOD Initiatives to Improve Financial Management

DOD has initiated a comprehensive, long-term effort to streamline its administrative operations in response to the President's call for improved DOD management in his February 1989 address to the Congress. Following the President's request, DOD completed the Defense Management Report (DMR) in July 1989, which identified a number of

measures to improve management and conserve resources. One of the initiatives, known as Corporate Information Management (CIM), is intended to (1) ensure the standardization, quality, and consistency of data from DOD's management information systems, (2) identify and implement management efficiencies, and (3) eliminate duplicate systems development efforts. A long-range goal of these initiatives is the implementation of a single accounting system to service all DOD organizations, including the three military departments.

On January 20, 1991, DOD established a single organization for all finance and accounting activities throughout the Department. This organization, known as the Defense Finance and Accounting Service (DFAS), is comprised of a headquarters and the various finance and accounting centers previously operated by the military departments and the Defense Logistics Agency. The former Air Force Accounting and Finance Center is now a component of DFAS and is known as DFAS, Denver Center.² DFAS operates under the direction of the DOD Comptroller with an integral part of its mission being the improvement of financial management. DFAS will also be responsible for complying with statutory and regulatory financial reporting requirements and preparing consolidated financial statements, including those of the Air Force.

Objectives, Scope, and Methodology

As a result of our audit work for fiscal year 1989, we issued 10 reports to various Air Force organizations.³ Those reports disclosed problems and deficiencies identified during our work and contained recommendations and suggestions for corrective actions. This report summarizes information previously reported to those organizations. It also reports on the progress that DOD and the Air Force made in implementing the recommendations in our February 1990 report.⁴ Also, we assessed the Air Force's ability to produce accurate and reliable financial statements in meeting the financial reporting requirements of the CFO Act.

The specific objectives of our fiscal year 1989 Air Force audit were to

²In this report, information which relates to Air Force systems, plans, and actions instituted before the organization of DFAS is attributed to the Air Force. Discussions held since January 20, 1991, with finance center officials are noted as being with DFAS officials.

³Appendix II presents a list of the reports issued during our fiscal year 1989 audit.

⁴In May 1991, we reported on the status of Air Force's interim corrective actions in our report entitled Financial Audit: Status of Air Force Actions to Correct Deficiencies in Financial Management Systems (GAO/AFMD-91-55, May 16, 1991).

- evaluate the adequacy and effectiveness of significant internal accounting controls;
- test transactions and account balances to substantiate their accuracy, completeness, and propriety;
- ascertain if expanded audit procedures and tests would allow us to audit certain accounts, primarily inventories and equipment, which we previously found to be unauditably; and
- evaluate the adequacy of the Air Force's consolidation and financial reporting procedures.

Originally, we planned to assess the reliability of the Air Force's fiscal year 1989 financial statements. However, during the course of our audit, the Air Force decided not to prepare such statements but to issue only the annual financial reports required by the Department of the Treasury. Therefore, we applied our audit procedures to those reports. Treasury uses those reports, along with similar reports from other federal agencies, to prepare consolidated financial statements which provide summary information on the financial condition and operations of the federal government. For the Air Force, this summary information covers the Air Force's financial management operations and accountability for its primary resources—equipment and weapons systems, inventories, facilities, and personnel.

To determine how the Air Force's accounting and financial management activities were supposed to operate, we reviewed pertinent policies and procedures. We evaluated and tested significant internal accounting controls and account balances to assess the reliability of reported financial data. In developing our audit tests and procedures, we considered financial management problems previously reported by GAO, the Air Force Audit Agency, the DOD Inspector General, and the Air Force pursuant to the Federal Managers' Financial Integrity Act (FMFIA) of 1982.

We judgmentally selected for audit 27 locations and organizations whose annual operations and appropriations accounted for a large percentage of resources and expenditures. Appendix III presents the locations where we conducted our fieldwork. At these locations, we judgmentally selected and tested key internal controls to determine if they were operating as intended and as described by the Air Force. Additionally, we tested the validity, accuracy, and reliability of specific accounting transactions and account balances. To test the accuracy of as many significant inventory account balances as feasible at the Air Logistics Centers (ALCS), we used the dollar-unit sampling methodology, which greatly

increased the probability that high-dollar investment items would be included in the sample.

We conducted our review from February 1989 through February 1991 in accordance with generally accepted government auditing standards. The Department of Defense provided written comments on a draft of this report. These comments are presented and evaluated in the "Agency Comments and Our Evaluation" sections at the end of chapters 2 through 6. Excerpts from DOD's comments are included in appendix IV.

The following chapters discuss specific issues or problems that DOD and the Air Force need to address in order to (1) improve internal controls, managerial accountability, and financial reporting and (2) meet the objectives of the CFO Act.

Nonintegrated Financial Systems Generate Unreliable Information

While the Air Force emphasizes budgetary fund control to ensure that obligations and expenditures do not exceed appropriation limits set by the Congress, it does not sufficiently emphasize accounting to ensure that its resources are properly controlled, accounted for, and reported. This lack of emphasis also prevents the Air Force from determining the cost of various operations and programs. The Air Force's accounting and financial management systems are not integrated under a departmentwide, transaction-driven general ledger and, consequently, much of the information generated by the systems is inaccurate and unreliable. Because of these limitations, the Air Force's general funds general ledger accounting system, a subsystem of the General Accounting and Finance System (GAFS),¹ generates inaccurate financial information that is of limited value for managing resources and monitoring operations.

During our fiscal year 1989 audit, we found billions of dollars of errors in the Air Force's accounting records and in its annual Treasury financial reports. After we informed the Air Force of the magnitude of errors in these reports, officials recalled the reports, made approximately \$62 billion of corrections, and submitted the revised reports to the Department of the Treasury. Additionally, we estimated that for fiscal year 1989, about \$20 billion of budgetary expenditures were not accurately recorded in, or could not be traced to, capital asset accounts in the general ledger subsystem of GAFS. Although a portion of this amount was satisfactorily explained by the Air Force, such as classified assets not being recorded in the accounting records for security reasons and correction of errors in the previous year's balances, much of the amount was attributable simply to weaknesses and deficiencies in accounting policies, procedures, and systems. Furthermore, we noted that consolidated trial balances prepared by the Air Force's major commands often included information from other commands or excluded information from the reporting command, thus reducing their value for managing, monitoring, and evaluating operations and programs.

The Air Force is aware of the deficiencies with its accounting systems and had begun an effort to develop a new base-level accounting system to replace the base-level portion of GAFS. However, DOD, as part of the Defense Management Report initiative to develop standard DOD-wide systems (specifically its Corporate Information Management (CIM)

¹The General Accounting and Finance System is the basic fund control, status of funds, cash accountability, and general funds general ledger for the Air Force. The general funds general ledger is a subsystem of GAFS and will be referred to as such within this report.

effort), transferred the military services' systems development budgets to a central account, and the Air Force cancelled its system development effort. DFAS is now charged with developing a standard DOD-wide system which may take 8 to 10 years to implement.

Information Produced by Accounting System Is Unreliable

Much of the information produced by the general ledger subsystem of GAFS is inaccurate and cannot be relied upon to conduct financial analysis or to manage and evaluate operations. We noted during our 1988 audit that the general ledger subsystem was not integrated with the budgeting subsystem in GAFS and, as a result, budgetary transactions did not adequately update proprietary account² balances. Also, essential accounts were not included, and certain account balances were generated by nonfinancial systems and recorded in the system for reporting purposes. The problems with the general ledger are so pervasive that accounting officials do not use many accounts for preparation of financial reports, but instead use information from other sources. Solutions to the deficiencies with the general ledger subsystem of GAFS are needed to facilitate the preparation of auditable financial statements.

Financial Structure Not Integrated

Title 2 of GAO's Policy and Procedures Manual for Guidance of Federal Agencies states that an agency's accounting system must be an integral part of its total financial management structure and must (1) provide sufficient discipline and effective internal control over operations to protect appropriated funds, cash, and other resources from fraud, waste, and mismanagement and (2) produce reliable and useful information on the results of operations. Accordingly, a general ledger, which includes all necessary proprietary accounts, serves as an integral part of an agency's financial management system and as an essential control mechanism by summarizing all of an activity's financial data for top management and decisionmakers.

OMB Circular A-127, "Financial Management Systems," requires that agencies establish and maintain a single, integrated financial management system which may be supplemented by subsidiary systems. Such systems are required to comply with applicable budget and accounting principles and standards and Treasury reporting requirements, and to

²Asset, liability, and expense accounts are examples of proprietary accounts. These accounts provide accounting control over financial resources from the time an appropriation is received until the applicable resource is consumed, sold, or otherwise disposed of.

produce financial data that are complete, accurate, and verifiable and developed from official records and systems.

Integrated, well controlled financial management systems help ensure that overall financial management operations and activities will be strengthened. The integration of budgeting and accounting provides a record of historical costs and performance data that is key to estimating future cost. Also, by integrating budgetary and accounting systems, controls can be established to ensure that assets acquired with budgetary resources are accounted for and controlled by the accounting system, i.e., the general ledger system.

As noted in our February 1990 report, GAFS was intended to serve as the Air Force's general ledger. However, it was not implemented in a manner which permits it to record, process, summarize, and report financial results for Air Force activities. The effects of budgetary transactions are not accurately and properly recorded in GAFS' general ledger subsystem which must rely on feeder or property systems for a number of balances.

Proprietary Accounts Are Not Properly Updated by Budgetary Transactions

As we reported in February 1990, the Air Force does not have an integrated, transaction-driven, double-entry³ general ledger. Consequently, budgetary transactions, such as incurring obligations and disbursing funds, processed by the fund control system do not accurately update proprietary account balances in the accounting system. For example, disbursements for the purchase of equipment recorded in the budgetary system are not necessarily accompanied by corresponding increases in the asset accounts. We estimated that in fiscal year 1989, approximately \$20 billion of expenditures for capital assets, although recorded in the budgetary accounts, were not accurately recorded or could not be tracked to proprietary accounts in the GAFS general ledger subsystem.

In fiscal year 1989, the Air Force expended approximately \$100 billion of appropriated general funds to carry out its mission and programs and collected reimbursements of about \$5 billion. Of the \$95 billion in net cash outlays, approximately \$3 billion was used to liquidate liabilities; \$30 billion to acquire, construct, repair, and modify capital assets such

³Under a double-entry system of accounting, the entry for each transaction is composed of two parts—debits and credits. Such systems help ensure that when a financial transaction is recorded, all appropriate accounts are updated. For example, to record the purchase of an aircraft in the proprietary accounts, the asset account, aircraft, would be debited (increased in this case) for the cost of the item while the contra account, cash/funds with Treasury, would be credited (decreased).

as aircraft, inventories, equipment, and facilities; and \$62 billion to pay for everyday costs of operations such as military and civilian personnel costs, operation and maintenance expenses, and technological research and testing.

The expenditures were processed, controlled, and reported by the Air Force's fund control/budgetary subsystem of GAFS, which we previously reported generally provided adequate control. Under an integrated financial management structure whereby budgetary transactions initiate related transactions in the accounting system, the expenditures would generally result in increases in asset and expense accounts or decreases in liabilities. However, since the Air Force does not operate an integrated system, the budgetary expenditures did not accurately update the asset, expense, and liability accounts.

For example, during fiscal year 1989, an estimated \$30 billion spent on capital assets was not reflected by similar increases in asset valuations within the GAFS general ledger subsystem. Capital assets reported in the general ledger system as of October 1, 1988, the beginning of fiscal year 1989, totaled \$226.3 billion. The reported valuation of these assets on September 30, 1989, the end of the fiscal year, was \$236.3 billion—an increase of \$10 billion. We compared the increase in these asset valuations with expenditures made from procurement and construction appropriations⁴ during the year and found that approximately \$20 billion of expenditures were not reflected in the general ledger accounts. Dispositions and losses of assets would account for part of the difference, but the GAFS general ledger does not always capture the value or costs of such transactions.

We presented our analysis to Air Force finance officials who indicated that they generally agreed with our method for conducting the analysis. However, they indicated that many of the transactions which cause undervaluation of the assets are accounted for and recorded in accordance with applicable regulations. Their explanations for part of the difference included:

- classified assets were not reported due to national security reasons;
- vehicles valued at \$3.1 billion were not properly recorded;

⁴In computing the total amount expended on capital assets, we used data from budget execution reports (DD Form 1176) for the three procurement appropriations (aircraft, missile, and other), the three military construction appropriations (Air Force, Air National Guard, and Air Force Reserve), and the family housing construction appropriation.

- aircraft and missiles were reported at standard costs and not at actual costs;
- equipment was transferred to and reported by the stock funds; and
- in accordance with generally accepted accounting principles, certain expenditures made from the procurement and construction appropriations, such as minor repairs to buildings and certain weapons systems modifications, should not be capitalized.

Regarding the Air Force's last point, although we agree that certain costs included in our estimate should not be capitalized, we were unable to measure the dollar value of such transactions due to the lack of detailed information in the records we used for the analysis.

GAFS Lacks Needed Accounts and Uses Account Balances Generated by Nonfinancial Systems

Because the GAFS general ledger subsystem is not integrated with the budgetary subsystem, expenditures for assets do not update asset valuations. Instead, certain asset balances are generated by Air Force property systems and recorded in the general ledger subsystem for reporting purposes. For example, aircraft, missile, and engine valuations are generated by property accountability systems operated by the Logistics Command. The systems, the Aerospace Vehicle Inventory Status Utilization Reporting System (AVISURS) and the Comprehensive Engine Management System (CEMS), track the existence, location, and capability of the assets. These systems use standard or unit costs rather than actual costs for valuation purposes. As we reported in February 1990, the standard or unit costs often do not equate to actual costs incurred to acquire the assets.

In addition, the GAFS general ledger subsystem does not have necessary accounts such as cash/funds with Treasury, unexpended appropriations, and invested capital. Instead, the balances for cash/funds with Treasury and unexpended appropriations included in the financial reports were obtained from reports generated by the Air Force's fund control system, and the invested capital amount was arbitrarily computed to make total liabilities and equity agree with total assets. Generally, these balances were compiled from the year-end closing statement (TFS-2108) and budget execution reports. Other necessary accounts, such as allowances for doubtful accounts receivable and dispositions/losses of equipment and inventories, are also not included in the general ledger. Generally, transactions which should be recorded in these accounts are instead recorded in one overall expense account, general

expense. This practice does not lend itself to the development of meaningful financial statements or determination of costs and losses that should be important for management purposes.

The GAFS general ledger subsystem also does not contain an account to capture and report the value of aircraft and missiles lost or disposed of by the Air Force. According to data provided by the Air Force, it lost or disposed of 701 aircraft and missiles during fiscal year 1989. These losses and dispositions resulted from crashes, accidents, in-flight destructions during testing, and transfers to other government agencies, museums, and schools. Using the Air Force's standard or unit costs for the subject aircraft and missiles as of September 30, 1989, we calculated that the total value of losses and dispositions was over \$1.7 billion.

Treasury regulations require that material losses and dispositions be reported as operating expenses if they occur with regular frequency, or as extraordinary items if they occur infrequently. We believe that due to the risk associated with the Air Force's mission and the number of such losses and dispositions annually, the Air Force should record the financial effect of these events as operating expenses. However, no accounts were established in the GAFS general ledger subsystem for such transactions and, therefore, they were not reported in the Air Force's fiscal year 1989 financial reports either as operating expenses or extraordinary items. In commenting on a draft of this report, DOD concurred with this finding and stated that in fiscal year 1990, the Air Force implemented procedures to report aircraft and missile losses as operating expenses in its financial reports for fiscal year 1990 and future years.

Certain GAFS Accounts Could Not Be Used to Prepare Financial Reports

As a result of GAFS' general ledger deficiencies and the unreliability of much of the financial information it produces, Air Force finance officials cannot rely on the system for much of the financial information needed for annual financial reports and must obtain data from alternative sources. The September 30, 1989, general funds trial balance contained 34 asset, liability, revenue and expense accounts, of which only 18 were used by the Air Force in preparing its annual financial reports.

Accounts contained in the GAFS general ledger subsystem such as accounts receivable, advances, prepayments, accounts payable, unearned revenue, revenues and expenses, were not used by the Air Force in compiling its financial reports because they were unreliable. The Air Force has indicated that the general ledger is often not the best source to use for much information needed for financial statements and

reports. Therefore, it is compelled to use other more reliable sources, primarily budgetary data bases, to derive information for its financial reports.

Examples of the differences reported in GAFS general ledger balances and the related amounts derived from budgetary sources and used to prepare the September 30, 1989, Treasury financial reports are presented in table 2.1.

Table 2.1: GAFS Account Balances and Related Amounts From Other Sources

Dollars in millions			
Account	GAFS balance	Balance reported in financial reports ^a	Difference
Accounts receivable	\$1,182.4	\$1,259.6	\$77.2
Advances	138.2	261.1	122.9
Accounts payable	13,241.9	11,815.3	1,426.6
General expenses	73,171.3	92,453.8	19,282.5

^aAmounts represent those reported to the Department of the Treasury in the Air Force's revised financial reports as of September 30, 1989.

Command-Level Trial Balances Did Not Include All Component Organizations

During our testing at the Air Force Systems Command (AFSC), we observed that the Command's trial balances—which provide account balances for the Air Force's consolidated financial statements and reports—did not include the results of transactions made by all Command organizations. This occurred because the Air Force allows host organizations⁵ to include the results of transactions by tenants in the host organizations' individual trial balances. The host organizations in turn submit the trial balances to their parent organization for consolidation purposes instead of reporting the tenant's financial information to its parent organization. According to the Systems Command's General and Cost Accounting Division Chief, this practice has been in effect for many years.

Generally accepted accounting principles require an entity with the ability to exert significant control over the policies, management, and funds of subsidiaries or organizational units to include the assets, liabilities, and results of operations for these activities in its consolidated financial statements. While the DOD Accounting Manual requires that

⁵ Air bases are generally operated by major commands, such as the Strategic Air Command and Tactical Air Command, but may have operating units from other Air Force organizations. These units are referred to as tenants while the commands with overall responsibility for the bases' operations are called the hosts.

only the overall Air Force financial statements be prepared on a consolidated basis, it is our view that Air Force major commands should include the financial transactions of all their component organizations, whether or not they are tenants of other organizations, in their consolidated financial reports. A consolidated presentation would provide a more complete picture of a command's operations, thereby allowing better management analysis and control of resources. Command-level trial balances which exclude significant balances or include such balances of other commands are of little value to management.

The Systems Command consolidated trial balance includes accounts for only 9 of the command's 31 organizations.⁶ Those nine organizations received approximately \$27 billion, or 83 percent, of the Command's fiscal year 1989 appropriated funds.

While the nine organizations received the majority of AFSC's funds, some of the organizations excluded represent significant segments of the Command's operations. For example, the Ballistic Systems Division is one of Systems Command's six product divisions and manages the intercontinental ballistic missile programs. The division is located at Norton Air Force Base, California, which is operated by the Military Airlift Command. During fiscal year 1989, the division received about \$1.8 billion, or approximately 6 percent of Systems Command's total appropriated funds, but its proprietary accounts were reported to the Military Airlift Command. This practice understated the results of the Systems Command's operations and overstated the Military Airlift Command's operations. In addition, it further reduced the usefulness of the trial balances to both commands for analyzing costs and planning, managing, and controlling resources.

Billions of Dollars of Errors Noted in Annual Treasury Financial Reports

As previously noted, the Air Force did not prepare consolidated financial statements in accordance with generally accepted accounting principles for fiscal year 1989. Instead, it issued the annual financial reports required by the Department of the Treasury. We identified tens of billions of dollars of adjustments that were needed to improve the accuracy of the reports and the underlying records from which they were developed.

⁶The nine organizations included in the September 30, 1989, trial balance were the Aeronautical Systems Division, Electronic Systems Division, Human Systems Division, Munitions Systems Division, Space Systems Division, Air Force Flight Test Center, Arnold Engineering Development Center, Eastern Space and Missile Center, and Rome Air Development Center.

The Department of the Treasury, under I TFM 2-4100, requires that federal agencies annually prepare and submit to Treasury timely and reliable financial reports which fully disclose the financial results of all programs and activities. Treasury uses the agency reports to prepare consolidated governmentwide financial reports, which provide information to the Congress and the public about overall government performance and stewardship. Consolidated federal financial statements should provide the Congress and the administration with information for determining the implications and consequences of fiscal and economic policy decisions. If the data in these reports are inaccurate, any analyses performed by users of the reports would likewise be of questionable value.

In a report to the Commander of the Air Force Accounting and Finance Center (now DFAS, Denver Center) dated July 20, 1990 (GAO/AFMD-90-109ML), we suggested over \$116 billion of adjustments to the Air Force's fiscal year 1989 Treasury financial reports. The net effect of our proposed adjustments would have been decreases of \$50.4 billion to assets, \$1.4 billion to liabilities, \$8.0 billion to revenues, and \$10.6 billion to expenses. The suggested adjustments were needed to (1) correct errors we identified in base-level and command-level trial balances and other financial reports which were transmitted to the finance center and included in the Treasury financial reports and (2) eliminate intra-agency balances and to correct errors made at the finance center in preparing the reports. Our proposed adjustments included approximately \$57 billion to record depreciation on certain general fund assets, such as buildings and aircraft, in order to more accurately report the Air Force's costs of operations.

The Air Force recalled and revised the financial reports and recorded approximately \$62 billion of adjustments that we suggested. The Air Force declined to make adjustments to record depreciation on its general fund assets. Air Force officials noted that executive branch financial reporting standards do not require depreciation on such assets. While current standards do not require agencies to depreciate general fund assets, we believe agencies should record depreciation in order to provide more accurate information on the costs of operations. Depreciation has governmentwide significance because some agencies record depreciation on general fund assets while others do not. The recently established Federal Accounting Standards Advisory Board will address issues such as depreciation accounting and recommend accounting standards

for federal entities. The Air Force submitted the revised reports to Treasury in October 1990. Appendix I presents Air Force's original and revised consolidated reports on financial position and operations.

Air Force's Efforts to Develop a New Accounting System Were Cancelled

As noted in chapter 1, DOD has initiated a long-term effort to streamline its administrative operations in response to the President's call for improved DOD management. A long-range goal of the DOD initiatives is to establish a single accounting system to service all DOD organizations, including the military departments. Consequently, DOD reduced the services' systems development budgets and directed them to reduce the number of system development efforts. Standardized systems resulting from Corporate Information Management are not expected to be implemented and operating for possibly as long as 8 to 10 years.

The Air Force is aware of the deficiencies with its general ledger system and since 1984 has annually disclosed in its reports to DOD prepared pursuant to the Federal Managers' Financial Integrity Act of 1982 (Public Law 97-255) that GAFS fails to conform with the principles and standards promulgated by the Comptroller General. The Air Force intended to replace the base-level portion of GAFS with a new system that reportedly would have corrected the long-standing deficiencies. However, the Air Force's effort to develop the new system, the Base Level Accounting and Reporting System (BLARS), was cancelled in February 1990 after DOD transferred the Air Force's systems development funding to a central DOD account. DFAS is now charged with developing a standard DOD-wide system. Consequently, the Air Force will have to continue to rely on its existing system for management purposes and for preparing financial statements in accordance with the CFO Act. Therefore, the deficiencies in GAFS need to be resolved so that basic financial information and controls are in place to manage, evaluate, and report operations.

Air Force Needs Reliable Cost Accounting Systems

Cost accounting systems should provide information for three broad purposes: (1) internal reporting to managers for use in planning and controlling routine operations, (2) internal reporting to managers for use in making nonroutine decisions, such as base closures or eliminating an aircraft wing, and (3) determining the cost of products and services for reporting the results of operations. Such systems are needed to provide reliable cost information to the Congress in order to oversee operations and assess alternative actions. In short, cost accounting is management accounting, and the need for reliable cost information is critical to DOD entities in the current budgetary environment.

The Air Force, along with the other military services, has an urgent need for reliable cost data for management purposes. DOD is scaling back its operations by closing bases, reducing the size of its forces, and consolidating and/or eliminating aircraft wings, army divisions, and other operations. Reliable cost information is crucial both to ensure that the right decisions are made and to measure and verify the impact of these decisions. In today's environment of decreasing budgets, it is vital that DOD spend its appropriations in the most efficient and effective manner. But to do this, it needs to have much better information on the costs of its operations than is currently available. Also, reliable financial information is needed to prevent and correct various financial management problems.

Shrinking budgets will also necessitate more efficient operations. Improving operational efficiency requires performance standards and measurements. Managers must know current costs in order to establish realistic goals and to be able to measure actual performance against those goals. DOD systems generally do not provide for this.

In this regard, we testified before the Subcommittee on Readiness, House Committee on Armed Services, in April 1991⁷ on DOD's planned implementation of the Defense Business Operations Fund. The Fund is a revolving fund which DOD anticipates will eventually finance virtually all support activities in the department.⁸ DOD hopes to use the Fund to gain greater control over the cost of DOD's support activities. We testified that DOD will not achieve this objective unless it has financial systems in place to operate the Fund in an efficient and businesslike manner.

In our February 1990 report, we stated that the costs of operating and supporting weapons systems are not accounted for or included in the Air Force's budget in a way that would allow the costs to be identified with specific types of weapons systems or operations. For example, neither DOD nor the Air Force is aware of the total operating and support costs for major organizational components, such as a fighter squadron. Also, not every cost element can be tracked directly to the budget. Existing systems are not capable of providing accurate and reliable cost information, which is necessary to effectively monitor program execution and to

⁷Defense's Planned Implementation of the \$77 Billion Defense Business Operations Fund (GAO/T-AFMD-91-5, April 30, 1991).

⁸The Defense Business Operations Fund was implemented in October 1991. As implemented, the Fund consolidated nine existing industrial and stock funds operated by DOD and the military services as well as five other DOD activities.

provide a basis for future program and budget planning. In the current environment of reduced defense forces, base closures, and constrained budgets, it is important that the Congress and DOD managers have reliable financial information for decision-making.

Conclusions

Due to the problems and deficiencies discussed in this chapter, the financial information generated by one of the Air Force's principal accounting systems, the GAFS general ledger, is unreliable and cannot be used by Air Force managers to conduct financial analyses and evaluate the results of operations. In order to manage the financial operations of the Air Force, managers must be provided with reliable, timely, and consistent information. Also, without such information, congressional oversight is inhibited.

DOD's comprehensive, long-term effort to streamline operations as a result of the Defense Management Report includes an initiative, known as Corporate Information Management, which embodies a number of objectives. One of the objectives is ensuring the standardization, quality, and consistency of data from DOD's management information systems. A long-range goal is establishing a single accounting system to service all DOD organizations, including the three military departments.

However, until this goal is realized, the Air Force will have to rely on current systems to produce data for managerial purposes and prepare the financial statements required by the CFO Act. In order to improve the reliability of such statements, the Air Force will have to ensure that budgetary transactions are more accurately reflected in proprietary accounts and all necessary financial information is compiled and reported. Efforts are needed to improve the quality of GAFS general ledger data and to help ensure that reliable data are provided for future financial management systems to be developed by DOD.

Previous Recommendations Still Appropriate

In our February 1990 report, we made several recommendations to the Secretary of the Air Force to correct deficiencies in the Air Force's financial management systems, including giving high priority to developing an integrated accounting system capable of generating reliable financial management reports on a timely basis. We also recommended in our February 1990 report that the Secretary of the Air Force direct his Chief Financial Officer to

- correct deficiencies identified in existing systems to the fullest extent possible and
- generate more reliable and complete financial information for reporting to the Department of the Treasury and for annual consolidated financial statements.

In August 1990, the DOD Comptroller concurred or partially concurred with these recommendations and stated that the Air Force would correct existing deficiencies to the extent possible and which are cost effective. The Comptroller also indicated that the CIM initiative was intended to resolve certain of the reported problems. We reported in May 1991⁹ that the Air Force had made some progress in implementing corrective actions, such as reviewing regulations and issuing communications to Air Force organizations which emphasized the importance of accurate financial reporting, developing procedures for recording aerospace vehicle losses, and for eliminating intra-agency balances. However, further actions are needed to resolve problems discussed in this chapter. Therefore, we reaffirm the above recommendations.

Recommendation

In view of the long-term nature of the CIM initiative in developing standardized, DOD-wide systems, we recommend that the Secretary of Defense direct the DOD Comptroller to give high priority to improving the accuracy and reliability of financial information included in GAFS.

Agency Comments and Our Evaluation

DOD concurred with our recommendation. In a September 12, 1991, letter to the Director, DFAS, the DOD Comptroller directed that interim actions be taken to improve the Air Force general ledger system. DOD also stated that considerable progress has been made toward improving the accuracy of Air Force financial reports since the end of fiscal year 1989. DOD stated that DFAS, Denver Center, has implemented all departmental "short-term fixes" which were identified to improve the accuracy and reliability of Air Force financial information. DFAS, Denver Center, has reportedly updated certain directives and procedures and issued guidance to Air Force field offices aimed at improving accounting and financial reporting.

Our observation on the pace of corrective actions indicates that DFAS, Denver Center, may have accelerated such actions after January 1991.

⁹Financial Audit: Status of Air Force Actions to Correct Deficiencies in Financial Management Systems (GAO/AFMD-91-55, May 16, 1991).

However, the need for corrective actions goes well beyond the finance center to the numerous field organizations. Actions cited by DOD, such as updating directives and procedures and providing guidance to field offices, are intermediate steps toward resolving accounting and financial reporting problems. Such actions by themselves do not necessarily mean that the problems will be corrected. Persistence over time by management will be required to achieve resolutions from the intermediate steps. The success of such actions can only be assessed by future audits or evaluations.

Reported Costs of Weapons Systems Are Unreliable

Air Force accounting systems do not record and report the actual costs invested in weapons systems (that is, aircraft and missiles), as required by the DOD Accounting Manual. As discussed in our February 1990 report, the Air Force does not value its weapons systems at actual costs but instead uses "unit costs," which often deviate substantially from the amounts actually expended to acquire the weapons. For example, the Air Force values its fleet of B-1B bombers at \$14.5 billion, which we estimate is understated by about \$7 billion. Also, the Air Force does not include in the valuations of the weapons the cost of materials it provides to contractors for the manufacture and assembly of weapons systems. Also it does not include capitalizable modifications¹ made to in-service systems that increase the useful lives and/or capabilities, as required by the DOD Accounting Manual. The Air Force's failure to include all of the costs incurred in acquiring weapons systems results in materially understated valuations.

Unless corrected, these deficient valuations will make the fiscal year 1992 financial statements required by the CFO Act less reliable. However, by using data from its fund control system to calculate actual expenditures, the Air Force could better account for and compile the costs of its weapons systems, particularly the newer, more costly systems.

The Air Force annually invests billions of dollars in weapons systems. During fiscal year 1989, the Air Force expended approximately \$11 billion to acquire and modify such assets. As of September 30, 1989, the Air Force reported the value of its unclassified aircraft and missiles at approximately \$97 billion, or about 30 percent of its total reported assets.² The CFO Act underscores the importance of federal agencies, including the Air Force, properly accounting for and reliably reporting on their investments in such assets in order to fulfill their fiduciary responsibilities and enhance resource management. Otherwise, taxpayers do not know the amount of the government's investment in the Air Force, and the cost of various types of operations cannot be computed.

¹The DOD Accounting Manual requires that the costs of additions, alterations, improvements, rehabilitations, or replacements that extend the useful life of an asset or its service capacity be capitalized in the value of the asset.

²This amount and the percentage are based on the Air Force's revised Report on Financial Position, submitted to Treasury in October 1990.

Weapons Systems Costs Are Understated

The Air Force does not follow the DOD Accounting Manual by valuing weapons at actual costs but instead uses unit costs which, we reported in February 1990, result in significantly understated values.

The Air Force Systems Command, which contracts with manufacturers to develop and acquire weapons systems, is responsible for initially recording the cost of weapons systems acquired. Controls at the point of purchase or when orders are placed ensure that funds will be available to procure the assets. Within the Systems Command, program managers monitor financial reports to ensure that funds are available to continue production of weapons systems. As progress payments are made on contracts, the Systems Command is required to record them in the GAFS work in process account.

After weapons systems are delivered to the Air Force, the Air Force Logistics Command (AFLC) tracks the location, readiness, and status of the systems. AFLC is also responsible for supporting, maintaining, and accounting for the systems. When a completed item, such as a B-1B bomber, is delivered to the Air Force, the DOD Accounting Manual requires that the cost of the item recorded by the Systems Command in the work in process account be transferred to the appropriate general ledger asset account (aircraft or missiles). However, the Air Force does not follow this procedure.

When the initial item of a particular class or type of weapons systems is delivered to the Air Force, the Air Force Systems Command transfers the related balance from the work in process asset account to the general expense account. AFLC separately records a unit cost in the Aerospace Vehicle Inventory Status Utilization Reporting System. There is no attempt to reconcile the unit costs recorded in AVISURS with amounts actually paid by the Systems Command. Air Force officials have stated that these unit costs were "initial fly-away costs"—the estimated average costs at the time the contractor delivered the first aircraft or missile. All subsequently delivered items of the particular class/type are valued at the same unit cost, which is not subsequently updated or revised, regardless of actual costs incurred. This valuation practice for weapons does not conform to the requirements of the DOD Accounting Manual, which stipulate that such assets are to be valued at the actual costs expended to acquire them.

AVISURS generates valuations for aircraft and missiles based on the unit cost and number of aircraft and missiles for each of the specific classes of aerospace vehicles. In our February 1990 report, we noted that the

valuations generated by AVISURS are substantially lower than the actual costs incurred for the assets. For example, we reported that as of September 30, 1988, the \$40.7 billion AVISURS valuations for the B-1B bomber and the F-15 and F-16 fighters were cumulatively about \$21 billion less than our estimates of their actual costs as compiled from budgetary reports. As of September 30, 1989, AVISURS valuations for the Air Force's unclassified aircraft and missiles were \$87.2 billion and \$9.9 billion, respectively, which we believe are materially understated because the valuations do not approximate the actual costs of the assets. While weapons systems costs appear to be materially understated in the Air Force's financial reports, our analysis indicates that similar costs reported to the Congress in Selected Acquisition Reports more closely approximate actual costs.

Air Force Can Develop More Reasonable Valuations for Weapons Systems

Although the Air Force did not compile and report accurate costs for its weapons systems at the time of our audit, it could develop more reasonable valuations by (1) compiling the historical costs, including the cost of government-furnished materials, from budgetary and procurement data for its newer, higher cost systems, (2) including the cost of modifications that increase the service life and/or capability, and (3) establishing values for older systems by appraisal or other reasonable bases.

The DOD Accounting Manual requires that assets, such as aircraft and missiles, that have an initial acquisition cost of at least \$5,000 and an estimated service life of 2 years or more be accounted for at cost. The cost of such assets are to include the value of any materials the government provided to the contractors. Also, the DOD Accounting Manual requires that the cost of any modifications which extend the life or enhance the service capacity of assets be reflected in the value of the assets.

Relatively New Weapons Systems Account for Bulk of Air Force Investment

As of September 30, 1989, the Air Force had 11,010 unclassified aircraft and 5,080 unclassified missiles cumulatively valued at \$97 billion. Many Air Force weapons systems are relatively old, with the average age of all active aircraft and missiles being 16.5 and 11.8 years, respectively, as of September 30, 1989. However, the bulk of Air Force's investment in aircraft is for relatively new systems in comparison to the average age of all aircraft. For example, the Air Force values each of its B-1B bombers at \$149.7 million and, as of September 30, 1989, the average

age of all B-1Bs was 2.3 years. In comparison, the B-52H bomber, a predecessor of the B-1B, is valued at \$9.4 million per plane and as of September 30, 1989, the average age of these aircraft was 27.7 years. Seven of the newer aircraft systems are listed in table 3.1.

Table 3.1: Recorded Values and Average Ages of Certain Air Force Aircraft as of September 30, 1989

Dollars in billions		
Aircraft system	System valuation	Average age (years)
A-10A	\$3.6	9.3
B-1B	14.5	2.3
C-5B	6.1	1.8
KC-10A	2.6	4.7
E-3	3.3	9.9
F-15	12.5	8.5
F-16	13.7	4.8
Total valuation	\$56.3	

Source: Values obtained from the year-end AVISURS report were based on the unit costs assigned by the Air Force.

The \$56.3 billion total valuation that the Air Force's AVISURS system listed for these seven systems represents 65 percent of the reported value of all unclassified Air Force aircraft at the end of fiscal year 1989. Based on our tests, the above valuations are materially understated. If the valuations were more reliably compiled, they would most likely constitute a higher percentage of total weapons systems costs.

Fund Control System Contains Data for Valuing Newer Systems

By using data from its fund control system, the Air Force could develop and maintain more accurate valuations for its weapons systems. As discussed in chapter 2, the Air Force already uses that system to obtain data for a number of accounts, including current period expenses, because such data are more reliable than the GAFS data.

The Air Force's fund control system uses codes, known as budget program activity codes (BPACS), to account for budgetary transactions and compile summary data by major programs within the procurement appropriations. For example, 10F16X and 10C17A are BPACS used to account for budgetary transactions, such as budgetary authority, obligations, and expenditures related to the procurement of F-16 fighters and C-17 cargo aircraft, respectively. Similarly, BPACS are used to track and compile financial data for modifications, ground support equipment, replenishment parts, and initial spares.

For fiscal year 1989, we used reports generated by the Air Force's fund control system to compile expenditures for the acquisition and modification of three relatively new aircraft systems (the B-1B bomber, and F-15 and F-16 fighters). As table 3.2 shows, the Air Force expended almost \$3.8 billion to acquire and modify these four aircraft systems in fiscal year 1989.

Table 3.2: Fiscal Year 1989 Expenditures to Acquire and Modify Selected Aircraft

Dollars in thousands			
Aircraft	Acquisition	Modifications	Total
B-1B	\$0	\$46,172	\$46,172
F-15	1,386,141	50,734	1,436,875
F-16	2,238,502	38,949	2,277,451
Totals	\$3,624,643	\$135,855	\$3,760,498

Note: The data used to compute the expenditures were for program years 1987 through 1989, the years for which detailed information by BPAC was available in the subject reports. Because the Air Force has a 3-year aircraft procurement appropriation, it has 3 years in which to obligate funds. For example, funds authorized in program year 1987 are available for obligation from 1987 through 1989.

Source: Air Force fiscal year 1989 reports on Appropriation Status by Fiscal Year and Subaccounts (data for program years 1989, 1988, and 1987).

Most Air Force procurement expenditures are made for relatively few systems. Generally, these systems represent the newest, most technologically advanced, and, therefore, the most costly systems in the Air Force's inventory. For example, of \$5.9 billion the Air Force expended in fiscal year 1989 to acquire aircraft, \$3.6 billion (61 percent) was spent to acquire two systems—the F-15 and F-16 fighters.

For the older, less costly systems, even though records documenting actual costs may no longer be available, more reasonable valuations can still be developed, possibly by appraisals. For example, as of September 30, 1989, the average age of the Air Force's 254 active B-52 bombers was 29 years, while their reported valuation was about \$2.2 billion, or an average unit cost of about \$8.5 million per aircraft. We believe that the valuation for the B-52 fleet, like the valuations for newer aircraft, may be understated. However, we could not ascertain the magnitude of understatement because records were lacking for the older aircraft. Just for the 5-year period from fiscal years 1985 through 1989, we estimate that the Air Force expended over \$1 billion to modify B-52s. Although this amount is substantial in relation to the overall reported valuation of the B-52 fleet, the modification costs were not capitalized in the asset accounts, as required by the DOD Accounting Manual. Doing so would provide better valuations for these older assets.

Government-Furnished Materials Excluded From Reported Costs

As we previously reported, Air Force unit costs used to value weapons systems do not include the cost of government-furnished materials, further distorting asset costs. Such materials include parts, components, assemblies, and other materials which the Air Force provides to contractors and which are consumed in production or become part of the end items. The Air Force, however, has not maintained accurate records of the amounts and costs of government-furnished materials included in weapons systems. We and DOD audit organizations have long reported that government-furnished materials are not adequately tracked and accounted for by DOD entities, including the Air Force, and that improved controls and accountability are needed.

Conclusions

At the time of our audit, the Air Force's procedures and systems for valuing weapons systems were not in accordance with DOD standards and principles. Valuations did not necessarily approximate actual costs, leading to unreliable reporting of both the government's investment in the Air Force and the results of Air Force operations. This was a major reason we were unable to issue an opinion on the Air Force's fiscal year 1988 financial statements.

Although DOD's Defense Management Report initiatives are to develop standardized systems that improve the quality, reliability, and consistency of financial data, benefits from such efforts are not expected to be realized in the short term. The Air Force needs more reliable financial data in the present so that the department can improve its asset accountability and meet the objectives of the CFO Act. These data need to include more reliable weapons systems valuations.

The Air Force will need more accurate asset costs to fulfill the objectives of the CFO Act. One of the act's purposes is to facilitate the production of complete, reliable, timely, and consistent financial information by federal agencies. Because the CFO Act requires that the Air Force produce financial statements for fiscal year 1992 and have then audited, the Air Force needs to develop procedures to ensure that 1992 asset valuations are as reliable as possible.

The Air Force can develop better valuations for its weapons systems, particularly its newer, more costly systems. In order to produce financial statements in compliance with the CFO Act, the Air Force will have to rely on its existing systems to compile the most reliable financial information feasible. The Air Force can do so by (1) utilizing data from its fund control system for newer weapons systems, (2) developing

values for other systems by appraisal or some other reasonable basis, and (3) properly maintaining and accounting for subsequent costs. These efforts will also enhance the reliability of future systems by making the data incorporated from existing systems more accurate.

Previous Recommendation Still Appropriate

In our February 1990 report, we recommended that the Air Force accumulate and report actual costs of weapons systems, which include acquisition costs, government-furnished materials, and modifications. The DOD Comptroller concurred with this recommendation and indicated that the CIM initiative provides for the development of DOD-wide requirements for an integrated capability to accumulate and report actual costs. We reaffirm the above recommendation.

Recommendations

We recommend that until an improved system is available, the Secretary of Defense direct the DOD Comptroller to develop

- methodologies to use data from the Air Force fund control system to develop and report more reliable costs for weapons systems, particularly for newer systems, and
- procedures for establishing values for older systems by appraisal or another reasonable basis.

Agency Comments and Our Evaluation

DOD concurred with our findings and first recommendation and noted that the use of expenditure data from the appropriation fund control system has been considered for developing more reliable costs for weapons systems. DOD stated that the exclusive use of that process would require extensive automated systems enhancements, involving significant time and prohibitive costs. However, DOD stated that, in preparing the fiscal year 1992 financial statements, it will attempt to develop the acquisition costs from the appropriate fund control systems for recent purchases of major equipment. When that is not feasible, DOD stated that it will disclose the alternate valuation methodology fully in the footnotes to the financial statements. We concur with this approach.

DOD partially concurred with our second recommendation and noted that it did consider establishing values for older weapons systems by appraisal and had determined that such a process would be overly expensive and time-consuming in relation to the anticipated benefit. However, DOD further stated that where information is readily available, the Department will consider using such information for preparing

financial statements. We recognize that there may be situations where establishing values for very old weapons systems would be overly expensive in relation to expected benefits. However, we would expect such situations to be the case for very old and nonoperational systems which would probably represent only a small portion of the overall value of Air Force's inventory of weapons systems.

Accounting and Controls Over ALC Inventories Are Inadequate

Deficiencies in inventory accounting and controls significantly increase unnecessary and avoidable costs to the Air Force and were major reasons why we were unable to express an opinion on the Air Force's fiscal year 1988 financial statements. As of September 30, 1989, the Air Force reported about \$64 billion¹ in inventories, of which about \$20 billion was for high-dollar investment items located at the five Air Logistics Centers and about \$6.2 billion was for items of the Systems Support Division (SSD) of the Air Force stock fund. We found that inventory records and accounts did not accurately portray either the quantities or the values of inventories at the ALCS. Our April 1991 report² discussed the internal control and financial reporting deficiencies at the ALCS disclosed by our fiscal years 1988 and 1989 audits and recommended improvements.

Specifically, we found that the ALCS' inventory records for investment items were inaccurate and unreliable because

- errors were made when recording transactions in perpetual inventory systems;
- computer programing errors resulted in duplicate reporting of inventories;
- internal controls designed to identify and correct errors were not operating as intended: potential errors identified by system edit checks were not researched and corrected in a timely manner, physical inventories were not properly performed, and reconciliations of perpetual records with the results of physical counts were not always performed;
- unserviceable and obsolete inventory items were valued the same as new items; and
- inaccurate values were assigned to many high-dollar items because Air Force inventory pricing policies were not followed.

Deficiencies in stock fund operations have reduced incentives for good inventory management and led to sharply increased prices for stock fund customers in recent years. Specifically, our work disclosed that (1) some customers were not being billed for goods purchased and (2) unnecessary costs were incurred by the Air Force in maintaining excessive inventories. Additionally, we identified at least \$278 million of

¹This amount was obtained from the Air Force's revised Report on Financial Position submitted to Treasury in October 1990.

²Financial Audit: Financial Reporting and Internal Controls at the Air Logistics Centers (GAO/AFMD-91-34, April 5, 1991).

errors in SSD trial balances resulting from various deficiencies and problems. Also, SSD cash balances reported at the end of fiscal year 1989 did not reflect the results of operations because September 1989 billings to customers were withheld to purposely delay cash collections, thereby in effect reducing the year-end cash balance. Air Force communications indicate that this was done to avoid possibly having to refund cash that the Secretary of the Air Force might have considered excess to the stock fund's needs.

Air Force Logistics Command Has Primary Responsibility for Managing and Reporting Inventory

The Air Force Logistics Command (AFLC) provides worldwide supply and maintenance support to Air Force units and other customers. AFLC has five ALCS, each of which has a unique mission in terms of the types of aircraft or missiles it supports. Each ALC stocks 150,000 to 270,000 types of inventory items. About 80 percent are classified as stock fund items, which are generally lower cost, expendable items, such as filters, gaskets, or small electronic parts. The remaining 20 percent are classified as investment items, which are generally more expensive and consist of such categories as equipment and repairable assemblies. Investment item inventory represents about 76 percent of the dollar value of ALC inventories.

AFLC allots budget authority to the ALCS to execute their programs, and the ALCS commit and obligate those funds for goods and services. ALCS report monthly to AFLC on the status of appropriated funds through a system called Data Base Transfer. ALCS report the values of assets and amounts of liabilities on a general ledger trial balance, which is submitted to AFLC as of each March 31 and September 30.

AFLC processes financial reports received from the ALCS. Data Base Transfer reports are consolidated and forwarded monthly to the Defense Finance and Accounting Service, Denver Center, formerly the Air Force Accounting and Finance Center (AFAFC). General ledger data are consolidated into an AFLC trial balance and forwarded twice a year to DFAS, Denver Center, which uses the data in Air Force financial reports and statements.

Physical Inventories Disclosed Inaccurate Perpetual Inventory Records

Using a statistical sample, we took a physical inventory of 1,771 investment items valued at \$1.83 billion at four of the five ALCs.³ Projecting our sample results, we estimated that (1) 18.3 percent of the perpetual records⁴ differed from what was actually in inventory and (2) \$14.8 billion of inventory records at the four ALCs contained dollar errors totaling about \$2.3 billion. This estimate of dollar errors consisted of approximately \$1.5 billion of overstated inventory records and \$0.8 billion of understated records, for a net overstatement of about \$0.7 billion.

Our projections were based on physical inventories done in October 1989 with records reconciled to balances as of September 30, 1989. Table 4.1 provides details, by ALC, of these physical inventories.

Table 4.1: Physical Inventory Results at Four ALCs as of September 30, 1989

Dollars in millions

	Air Logistics Centers				Total
	Ogden	Oklahoma City	Sacramento	San Antonio	
Value of items inventoried	\$514.2	\$282.6	\$706.3	\$324.6	\$1,827.7
Amount of understated records	18.2	8.5	5.2	13.5	45.4
Amount of overstated records	102.1	3.3	102.7	30.2	238.3
Total value of errors	\$120.3	\$11.8	\$107.9	\$43.7	\$283.7

ALC officials recognize that the perpetual inventory records have been inaccurate over the years. In an attempt to compensate for this problem, ALC managers have developed additional procedures to increase the accuracy of data used in determining the amount of inventory required for operations. For example, although managers use information from the stock control and distribution system to provide supplementary data on inventory balances, they may request special physical inventories to ensure that they have accurate amounts when computing requirements for high-dollar or critical items.

GAO, the DOD Inspector General, and the Air Force Audit Agency have previously identified inventory management as a serious problem. In

³We were unable to conduct physical counts at the Warner Robins ALC, Warner Robins Air Force Base, Georgia, because a new automated warehousing system was being installed at the time of our work.

⁴Perpetual inventory records are used to record all receipts and withdrawals of each item of inventory. Perpetual records are intended to maintain control over and assurance of inventory levels.

addition, we and OMB have identified inventory management as one of the high-risk areas facing the federal government. The use of inaccurate perpetual inventory data by ALC officials in deciding the amounts of items to procure will result in inaccurate budget requests and overbuying or underbuying of items needed by the Air Force to accomplish its mission.

While AFLC officials acknowledged the possibility that inaccurate inventory records may result in inappropriate procurements, they stated that many variances in inventory balances are corrected through day-to-day supply operations, such as location surveys, location reconciliations, and the ongoing physical inventory process. However, AFLC officials have also acknowledged that problems exist and contribute to inaccurate data in the Air Force's repairable items requirement determination system. Because of the significance of these problems, AFLC is planning to establish a permanent office to correct the problems with the accuracy and timeliness of data. In addition, since 1987, AFLC studies have shown that data on total worldwide investment items are inaccurate because of system software problems and weak controls over the integrity of data processed by different reporting systems. While some weaknesses have been corrected, the inaccurate reporting continues to be a major problem confronting AFLC. The following sections discuss causes of problems that result in inaccurate investment item inventory.

Transaction Processing Errors Caused Many Inaccurate Inventory Records

Periodically, the ALCS conduct physical counts of inventories to ascertain the accuracy of perpetual records. After the physical counts are completed, any differences between the counts and records are referred to a research process that attempts to identify the cause of the errors. The ALCS' research and our review found that most inventory errors were due to the incorrect recording of transactions.

In accordance with AFLC Regulation 67-9, errors under \$16,000 generally receive limited research. Such research often produced no conclusive results. For errors over \$16,000, however, ALC staffs researched item transaction histories and reviewed subsidiary inventory systems. Staffs generally found the cause for these errors; for errors exceeding \$500,000, the cause was almost always identified. The research process commonly identified errors involving transactions that were either inaccurately or incompletely recorded in the perpetual inventory system. Research found examples where a shipment of material was made, but the corresponding reduction to the perpetual inventory record was not recorded. Other examples included (1) receipts of material for which the

wrong quantity was recorded or (2) receipts of material which were not posted to the perpetual record.

System Problems Caused Duplicate Reporting of Inventories

In fiscal year 1988, the ALCS implemented the item manager stock control and distribution system, which passes inventory data to the financial inventory accounting system. Our audit disclosed that inventory valued at about \$2.6 billion was recorded in this system as well as other inventory systems as of September 30, 1989, resulting in duplicate reporting. Programming errors in the new system caused this duplicate reporting of inventories.

Our fiscal year 1989 analyses of changes in inventory balances at the five ALCS showed substantial growth in inventories reported through the item manager stock control and distribution system. After we advised ALC and AFLC officials of this growth trend, they determined that a programming error was causing duplicate reporting of inventories.

Comptroller staff at the Ogden ALC followed up on information we presented on inventory growth and adjusted their general ledger to remove the duplication. However, the other four ALCS forwarded their final general ledgers to AFLC with the duplicate inventories in the accounts. Our review of the AFLC's consolidated general ledger forwarded to the Air Force Accounting and Finance Center showed that the duplications were passed to that level.

Errors Identified by Systems Edit Checks Were Not Properly Investigated

The financial inventory accounting systems at each ALC are programmed with edits to identify possible high-dollar errors in information they receive from the perpetual inventory systems. Because potential errors were not adequately investigated, some high-dollar errors caused overstated inventories in the general ledgers at Ogden and Sacramento, leading to overstated balances totaling \$784 million as of September 30, 1989. Prompt investigation of these errors provides the opportunity to correct data in the perpetual inventory system used for supply operations and to help ensure reliable financial reporting. The following examples were identified at the Ogden ALC.

- A July 1989 exception report identified the balance recorded for a type of digital indicator as questionable because an unusually large receipt transaction (10,021 units at \$20,720 each, for a total transaction amount of \$207,630,911) had been recorded in the perpetual record. Although the dollar amount was extraordinarily large, this transaction was not

researched. After we advised ALC staff of this, they researched the transaction and found that the quantity should have been only 21. The Ogden ALC's inventory balance was not reduced for this transaction until January 1990, leaving the perpetual inventory record overstated by 10,000 units and \$207 million for over 6 months.

- A September 11, 1989, edit list identified a \$333 million transaction in a subsidiary supply system. The edit is designed to note any transaction over \$10 million so that the transaction can be verified. This transaction was not researched even though it represented over 10 percent of the entire dollar value of the off-base ammunition inventory for which the Ogden ALC was accountable. On September 30, 1989, the computer performed a month-end procedure which recorded the \$333 million transaction into the general ledger account. That is, the procedure brought the financial inventory accounting system and the general ledger into balance with the underlying subsidiary supply systems by adjusting the general ledger data to agree with the subsidiaries. After we advised Ogden ALC staff of this high-dollar transaction, they found that the transaction should have been posted for only \$888,000. It had resulted in an overstatement of \$332 million in the general ledger.

Our audit tests at the Sacramento ALC disclosed three similar situations causing errors of \$245 million in perpetual inventory records. Each overstated the quantity of the item by 10,000 units. These three transactions were researched and corrected only after we disclosed them to ALC officials.

ALC officials told us that they had not researched these discrepancies prior to our notification because of staffing shortages. When we briefed top AFLC officials on this matter, they stated that staffing shortages were severe, but they also stated that more training was needed to ensure the full utilization of limited staff. They concurred that research needed to be completed, especially on high-dollar transactions.

All five ALCS made billions of dollars in automated inventory adjustments to arbitrarily force general ledger accounts into balance with the perpetual inventory records. In spite of the billions of dollars involved, the ALCS were not determining the causes for the large differences between balances in the general ledger and perpetual inventory systems, thus substantially increasing the risk of entering erroneous transactions into ALC general ledgers. Further, failure to conduct research on these adjustments violates the provisions of AFLC Regulation 177-24, which requires that research be conducted when amounts are determined to be significant.

Untimely Correction of Erroneous Records Increased Error Rate

Inaccurate inventory records can mislead managers on the availability of required items for current operations as well as quantities to be included in budgetary requests. Our work revealed that perpetual inventory records known to contain high-dollar errors were not promptly corrected. Even when the amounts of the errors were known, the ALCs did not correct records until they had completed research to determine the causes, a process which often took weeks or months. However, AFLC Regulation 67-9 states that the adjustment must be processed within 21 days even if the discrepancy cannot be resolved.

We tested how long it took to research the errors identified by our physical inventory sample. Our tests showed that ALCs did not complete research within 21 days on 36.5 percent of the errors. Furthermore, noncompliance was most frequent on errors over \$500,000, where 63.2 percent of the errors were not researched within 21 days, leaving high-dollar errors uncorrected for extended periods. Table 4.2 illustrates the extent of noncompliance with research requirements for errors over and under \$500,000.

**Table 4.2: Sample of Noncompliance
With Inventory Error Research
Requirements**

Errors and research time	Error amounts		Total
	Over \$500,000	Under \$500,000	
Errors researched	95	341	436
Errors not resolved in 21 days	60	99	159
Percent	63.2	29.0	36.5

While some research delays exceeded the 21-day criteria by only a few days, 68 of the 159 errors were in research for over 60 days.

ALC managers stated that lengthy research is sometimes necessary to ensure that the cause of high-dollar inventory variances is correctly identified. AFLC officials agreed but also acknowledged that ALC staff may leave high-dollar errors in research status rather than admitting to an error exceeding \$500,000. As discussed below, such errors, which must be processed through the ALC Commander's office, are ignored if not resolved in 180 days.

DOD concurred with our finding but stated that customer support is not affected by the delays in correcting errors since priority requisitions are processed. DOD further stated that the AFLC policy regarding correcting errors will be reiterated and enforcement methods established.

Results of Some Physical Inventories Were Ignored

Some high-dollar inventory errors were uncorrected because the physical inventory results were simply ignored or "cancelled" rather than processed as inventory adjustments. Cancellation of an inventory at an ALC means that the inventory count is never entered into the inventory record, making it appear that the physical count was never made and leaving a known error in the perpetual inventory record.

We reviewed selected items on which inventory cancellations had occurred at the Ogden ALC and found serious problems in inventory records. We counted 14 high-dollar items on which cancellations had occurred in fiscal year 1989 and found perpetual inventory errors in all 14. For example, on January 24, 1990, we counted 640 guided missile launchers in the warehouse; however, only 579 items were recorded on the perpetual inventory record. At the time of our test count, the inventory error (61 items) amounted to \$1.31 million. An ALC count of this item had been cancelled in September 1988. The cancelled inventory discrepancy then was \$1.25 million. The item was counted and cancelled again in April 1989, when the discrepancy was \$1.27 million.

In our view, this is an example of a significant inventory error that ALC staff were aware of but left in the system to avoid acknowledging a high-dollar inventory adjustment. From September 1988 through January 1990, the perpetual inventory record for this item was understated by about \$1.25 million. If an inventory manager had used this information in a requirements decision, an excess quantity might have been purchased. Furthermore, year-end inventory financial reports for fiscal year 1989 included this \$1.25 million error.

High-dollar errors, especially those exceeding \$500,000, are generally retained in the ALC research process until a cause for the error can be identified and the appropriate corrections are made. After research is complete and even if no cause is found, AFLC policy requires that a physical inventory adjustment be processed and, for errors over \$500,000, be approved by the ALC Commanding General. According to Ogden ALC staff, cancellations were sometimes used to avoid making, and having to report to ALC management, a high-dollar inventory adjustment. We were informed that items are often kept in research for extended periods, sometimes exceeding 180 days, and then cancelled because the data are old. This practice is a violation of an AFLC policy memo, dated April 1988, which prohibits the use of cancellations to avoid high-dollar adjustments and states that extensive research time is not a valid justification for cancellations.

Warehousing Practices Did Not Comply With Established Procedures

Errors in perpetual inventory records are also frequently caused by problems in warehousing practices at ALCs. During fiscal year 1989, we observed ALC physical inventory procedures and noted that although Air Force personnel generally complied with inventory guidelines and performed accurate counts, required recounts were not always made. When the person counting the inventory enters the quantity into the computer, the computer compares it to the perpetual record quantity in the system. If the data disagree, the computer automatically demands a recount but does not disclose to the warehouse worker the quantity or amount recorded in the system. We observed several occasions on which the warehouse worker simply re-entered the original count rather than recounting the item as required.

Although certain additional controls exist to identify inaccurate counts, failure to recount substantially increases the risk that incorrect data are being entered into the inventory system. For example, at the Ogden ALC, an internal evaluation found over \$800,000 of inventory (122 items) that had fallen from pallets and had either dropped to the floor or were lodged between storage racks. Properly conducted recounts would increase the probability that such mislocated items would be discovered. In commenting on a draft of this report, DOD stated that subsequent quality checks on counts are routinely performed to ensure the integrity of physical inventories.

Internal Control Breakdowns and Failure to Conduct Reconciliations Led to Large General Ledger Errors

During fiscal year 1989, we found errors totaling \$1.4 billion in general ledger accounts for inventories. The errors primarily resulted from inadequate control procedures over general ledger balances. The errors would have been identified if the general ledger account balances and supporting data in subsidiary systems were properly controlled and reconciled as required by federal internal control standards and Air Force Regulation 177-101. At every ALC we visited during our audit, we found inadequate general ledger accounting procedures.

The following examples illustrate significant problems in general ledger balances that our audit disclosed.

- At Warner Robins ALC, we found \$490.4 million in accounting errors as of September 30, 1989. The "material in stores—other" account was overstated by \$443.6 million due to erroneous postings to the account during the year. In addition, the account for ammunition stored with other government agencies was understated by \$46.8 million. This

understatement was caused by clerical posting errors. For example, several inventory items were recorded at zero value when, in fact, they had a value of \$24.4 million.

- At the Sacramento ALC, the account for progress payments to contractors was overstated by \$100 million because data in the Central Procurement Accounting System was incorrectly reconciled when compiling general ledger information.

Table 4.3 summarizes the \$1.4 billion in general ledger errors in inventory accounts that our audit tests identified.

Table 4.3: General Ledger Errors in AFLC Inventory Accounts in Fiscal Year 1989

Dollars in billions	
Reason for error	Amount of error
Account not accurately reconciled to subsidiary system	\$0.1
Subsidiary system errors not researched and recorded on the general ledger	0.8
Accounting errors in posting to accounts	0.5
Total	\$1.4

DOD concurred with our finding and stated that the AFLC headquarters directed installations to reconcile monthly the stock control and distribution system inventory balances with accounting system balances. Also DOD stated that AFLC Regulation 177-24 was changed to incorporate the policy on reconciliations.

Inventory Valuation Policies and Practices Contribute to Inaccurate Inventory Values

We previously reported in February 1990 that two key factors contributed to improper values being reported for inventories. First, Air Force policies do not require reduced valuations for unserviceable and obsolete inventory, as required by generally accepted accounting principles. Second, inaccurate values were assigned to many items because pricing policies were not followed. Generally, Air Force policies require that each item in the investment item inventory be valued at a standard price.

Unserviceable and Obsolete Inventory Values Overstated in Financial Reports

Because the Air Force's inventory pricing policy does not require different valuations based on an item's condition, unserviceable and obsolete items are valued the same as new items. ALC inventory condition codes show that about 58 percent (\$11.4 billion) of the investment items at the five ALCs are unserviceable; that is, they need repair or restoration before they can be issued to a customer. Although the network of

inventory systems at the ALCs contains historical data on the cost to repair some of the inventory items, no adjustment for repair costs is made to the general ledger valuations.

Generally accepted accounting principles require that the value of inventory items be reported at the lower of cost or market value. Consistent with the principles upon which the requirement is based, we have taken the position that (1) the value of broken repairable items⁵ should be reduced by the cost to repair the items and (2) the value of broken items that cannot be repaired and of obsolete items should be written off or reduced to their salvage value. As broken items are repaired, the inventory value should be increased for the repair cost.

We analyzed ALC investment item inventories by Air Force condition codes using the ALC's inventory data base. Table 4.4 shows that billions of dollars of Air Force inventory is in unserviceable condition.

Table 4.4: Unserviceable Investment Item Inventory as of September 30, 1989

Dollars in billions			
ALC	Total investment item inventory	Unserviceable inventory	Percent unserviceable
Ogden	\$3.9	\$2.4	61.5
Oklahoma City	3.6	2.0	55.5
Sacramento	3.4	2.0	58.8
San Antonio	3.9	2.0	51.3
Warner Robins	4.9	3.0	61.2
Total	\$19.7	\$11.4	57.9

Note: The ALCs had balances on hand in four different condition codes which identify unserviceable inventory: E (limited restoration-use), F (repairable), G (incomplete), and P (reclamation). About 94.6 percent of the unserviceable inventory at ALCs was code F, repairable.

We obtained historical data on the actual repair cost for a sample of 349 "F" condition (repairable) items at the four ALCs where we conducted sample physical inventories. For these items, we estimated that repair costs amounted to 17.6 percent of the items' book value. If the actual costs of repair were applied to the \$11.4 billion of unserviceable inventory at the five ALCs, values would be written down by approximately \$2 billion.

Reporting the thousands of unserviceable items at the same value as fully serviceable items, when many would require a significant dollar

⁵Repairable items are those that, if damaged, can be repaired for less than the cost of a new item. DOD refers to these items as repairable whether they are new or used.

investment before they could be used, overstates inventory values on financial reports. Such a flaw in financial reporting misleads those trying to analyze inventory data.

The Air Force agreed that unserviceable items should be valued separately from serviceable items. The Assistant Secretary of the Air Force, Financial Management and Comptroller, stated in his March 8, 1990, testimony before the House Committee on Armed Services, Subcommittee on Readiness, that the Air Force intends to program information into its inventory management systems that will compute a value for unserviceable material. In August 1991, an Ogden ALC official informed us that the Air Force had not modified its systems to compute a value for unserviceable items. According to the official, such a change will be part of a larger effort to include investment items in the stock fund and is not expected to be completed until October 1992.

Inventory dollar values are further overstated because obsolete assets are valued the same as serviceable assets on financial reports. Because there is no current demand for the items and they will probably never be used, their assigned values should be eliminated from inventory financial reports. In the meantime, the ALCs have not clearly defined which inventory items are obsolete, and the amount of obsolete AFLC inventory is unknown. When the utility of inventory items is no longer as great as their cost, or standard price in the case of the Air Force, their values should be written down to market value, whether the cause is obsolescence, physical deterioration, or other reasons.

We observed relatively high-dollar value electronic and radar items at the Sacramento ALC that were condition coded "F" (repairable) but were apparently obsolete. These items were placed in outside storage yards in unlocked containers. ALC staff informed us that the material had been there for many years, some since the end of the Vietnam War. Examples of items we saw included two radar sets, valued on the inventory records at \$2 million each, and six containers of radio sets valued at \$150,000 each. Determinations of the utility and future need for such items should be made and, if there is no future operational use or demand, then the Air Force should appropriately dispose of the items. Reducing the value of obsolete items as soon as it is determined that they are no longer required would more accurately report inventory values.

ALC Inventory Valuation Practices Contribute to Inaccurate Inventory Values

Other misstatements of ALC inventory values occurred because established procedures were not followed and clerical errors were not detected. Our analysis of 329 high-dollar items valued at \$804 million found that 112 (34 percent) were incorrectly valued, resulting in an overstatement totaling \$464 million. Table 4.5 summarizes the results of our pricing analyses.

Table 4.5: Inventory Pricing Analysis Summary

	Ogden	Oklahoma City	Sacramento	San Antonio	Warner Robins	Total
Items tested	63	52	82	45	87	329
Items not complying with Air Force pricing policy						
Overpriced	10	16	21	7	18	72
Underpriced	7	17	8	4	4	40
Total	17	33	29	11	22	112
Percent not complying	27	63	35	24	25	34

Air Force policy for valuing investment item inventory provides that each item will be valued at a standard amount. This value is generally based on the cost of the most recent procurement of the item plus a 3-percent surcharge for government-furnished materials and transportation. According to this policy, all existing items in the inventory should be updated with a new standard cost when the price the Air Force pays for an item changes. Therefore, all items of a particular stock number are valued the same, and the value of inventory is computed by multiplying the quantity on hand by the standard cost.

Incorrectly valued aircraft modification kits accounted for \$400 million of the \$464 million in overpricing identified by our analysis. Kits are valued based on an estimated acquisition cost, which is entered in the system. After the kit has been procured, the original estimate is usually not updated, as required, for the actual cost.

An example of an overvalued kit at the Sacramento ALC illustrates the problem. The Sacramento ALC had 172 modification kits, each of which had an estimated standard cost of \$1,500,000. After meeting with the manager for this item, we determined that the kit should have had a standard cost of \$13,342, based on the latest cost to the Air Force. As a result of this item, Sacramento ALC's inventory account was overstated by \$255.6 million as of September 30, 1989. Sacramento ALC officials

explained that kits are not included in the same system as other investment items and that the kits' cost updates are not triggered automatically. Consequently, special actions are required to update kit costs; due to an oversight, the cost of this item had not been updated. After we advised ALC officials of the problem, they corrected the standard cost for this item in February 1990.

We also found other errors when items were not updated based on the latest procurement price. For example, a main landing gear door for the B-1B bomber was valued in the ALC inventory records at a standard price of \$315,980 each. We met with the item manager and determined that this door should have been valued at \$62,600. The \$315,980 value had been recorded in the inventory system based on a 1982 initial estimate but had not been updated with the latest procurement price, as required by Air Force policy.

Inaccurate inventory prices not only cause financial reporting errors, but can also distort budgeting for procurement requirements when inaccurate prices are used to determine budgetary needs. ALC officials emphasized, however, that they do not routinely accept the standard price in the inventory system when computing requirements and budgets. Because they know that these prices are sometimes unreliable for projecting future costs, they try to obtain more accurate pricing from other sources. This example shows how the lack of system integrity creates problems in financial management of inventory. Whenever a decision needs to be made, the existing reporting systems are circumvented to obtain accurate data.

Inaccurate Accounting in the Stock Fund

In addition to the problems with investment item inventory, we identified deficiencies in accounting and controls over inventory of the Systems Support Division of the Air Force stock fund. These deficiencies undermined the stock fund's incentives for good inventory management and led to losses resulting in higher administrative surcharges. Our audit disclosed (1) billing problems, (2) excessive inventories resulting in losses from disposal of unneeded items, and (3) major errors in year-end account balances equal to about 30 percent of sales. Also, improper changes in collections processing procedures affected reported amounts of cash on hand.

Stock Fund Financial Operations

The Air Force stock fund is used to manage centrally procured inventory items primarily required by Air Force organizations. The Air Force provides relatively low dollar value supplies to authorized customers through eight stock fund divisions. SSD, one of the largest of these divisions, sells weapons systems-related parts to its customers, which are almost always DOD units or certain foreign governments. SSD is managed by AFLC and records about \$890 million a year in net sales of parts. ALCS sell the SSD items and bill customers for those sales principally through an automated billing and collection system called Interfund. For those customers not in the Interfund system, the ALCS prepare manual bills.

Air Force stock funds operate under a revolving fund concept, whereby sales revenue generates funds which are then used to replenish inventory levels. SSD prices are based on the replacement cost of material and include a percentage added on, or surcharge, to cover operating costs. Managing the purchase and distribution of stock fund items in this manner allocates costs to the customers that use the items and provides an incentive for customers to order only the items they need. Successful operation of the Air Force stock fund depends largely upon predicting and maintaining proper inventory levels.

Improper Billings Contributed to Increased Prices

Proper billing practices are essential if DOD agencies and foreign governments, which comprise most SSD customers, are to be properly charged for the items they receive and if the stock fund is to collect the related revenue. However, we found major problems in billing for SSD sales. Our tests disclosed weaknesses in internal controls for recording sales transactions. Furthermore, documentation for some transactions was incomplete. Finally, the supply systems did not contain edit checks to reject questionable transactions. As a result of errors and omissions in source data used for billing purposes, accounting personnel could not correctly bill customers for all issuances of SSD material.

Requisition forms are used to obtain and process items received by customers from the supply system. Sales transactions are then automatically created in the financial system based on data on these forms. We found that supply system forms used to record data on sales transactions at the San Antonio ALC did not have space for key financial codes needed to accurately record the transactions. At the Ogden ALC, sales records sometimes contained erroneous codes which, when processed into the automated billing system, resulted in charges to incorrect appropriations and to Air Force units that were not SSD customers. The

billing system rejected many sales transactions because they contained errors and were not corrected before they were submitted for billing.

Since the ALCs did not maintain consistent or complete information on sales transactions which were not properly billed, we could not determine total sales revenue losses caused by billing problems. For example, when sales documentation at the San Antonio ALC was inadequate to properly bill a customer, the original sales transaction was treated as a clerical error and removed from the accounting records. At the Sacramento ALC, however, such transactions were reversed and rebilled. No estimates were available on the amount of sales transactions eliminated from ALC records or kept on the records but not successfully rebilled in fiscal year 1989.

To estimate losses caused by billing problems in fiscal year 1989, we performed additional audit work at the Ogden ALC. We examined receivables listings showing the age and amount of receivables and journal vouchers documenting write-offs. Top officials in the Ogden ALC comptroller's office stated that an average of 20 percent of the dollar value of rejected sales transactions was never collected. Using that percentage, we estimated that the Ogden ALC did not bill customers for about \$5.5 million in fiscal year 1989. In addition, we identified journal vouchers documenting write-offs of about \$3.4 million in specific accounts receivable. The write-offs were caused by errors and omissions in billing data and unexplained differences in reported account amounts which researchers could not resolve.

AFLC officials responsible for SSD accounting and systems expressed concern over the ALCs' billing process. They stated that they were aware of the need to better control sales data entered in computer systems. These same officials acknowledged that any losses of revenue from sales of SSD material would increase surcharge rates.

Excess and Obsolete Inventory Items Result in Losses

Large quantities of excess and obsolete stock fund inventories at the ALCs contributed to SSD operating losses. When we analyzed inventory balances for the base support stock record account, which reflects over 95 percent of all SSD retail activity, we found that inventory was extremely large in relation to sales, as shown by table 4.6.

Chapter 4
Accounting and Controls Over ALC
Inventories Are Inadequate

Table 4.6: Years of SSD Inventories on Hand as of September 30, 1989

Dollars in millions

ALC	Inventories	Net sales in fiscal year 1989	Years of inventory
Ogden	\$784.6	\$90.9	8.6
Oklahoma City	1,684.6	242.7	6.9
Sacramento	554.3	78.1	7.1
San Antonio	1,918.9	323.4	5.9
Warner Robins	1,215.7	150.9	8.1
Total	\$6,158.1	\$886.0	7.0^a

^aThis is a weighted average computed by dividing total inventories by total net sales for the year.

Source: Data from Base Support Stock Record Account

The weighted average years of inventory at these five ALCs was 7 years. Although stock fund analyses prepared by the Air Force's Accounting and Finance Center contained no standard for the overall inventory to sales ratio, we believe that 7 years of inventory is clearly excessive. SSD items are procured based on individual item requirements computations with controls in place whose purpose is to ensure valid requirements; however, the accumulation of 7 years of inventory raises questions as to the effectiveness of those controls and overall management of inventories.

Under AFLC's program to dispose of excess and obsolete inventories, SSD recorded a loss from disposal of over \$146 million in fiscal year 1989. This loss was equivalent to about 16 percent of fiscal year 1989 sales to customers and was a cause for increasing the price of SSD items by \$180 million in fiscal year 1990.

High inventory levels increase operating costs and surcharge rates. Appropriations are invested for years in stock which may not be sold or may never be needed by customers. During that time, the Air Force has to pay the cost of storing, safeguarding, and handling the extra items.⁶ Identifying and disposing of inventories no longer in demand would reduce such operating costs.

⁶Prior to fiscal year 1991, Air Force operation and maintenance appropriations funded storage, security, and holding costs for stock fund inventories. Such costs are now funded by the stock fund.

Tests Showed Major Errors in SSD Trial Balance Reports

The ALCS reported inaccurate inventory and financial data to AFLC managers during fiscal year 1989. These data were then used to assess the results of operations, calculate annual surcharge rates, and manage stock fund activities. Our tests of SSD records disclosed numerous reporting errors in stock fund trial balance reports caused primarily by inadequate controls over accounting and reporting functions, including a lack of clear guidance for ALC accounting personnel.

Our tests of SSD trial balances for fiscal year 1989 disclosed errors totaling over \$278 million resulting from (1) mistakes in accounting entries (\$173 million), (2) errors in inventory data provided to accounting personnel (\$79 million), and (3) problems with the timing of accounting entries and reports (\$26 million). Because amounts for some accounts included in trial balance reports did not accurately reflect activities for the year, we believe that financial information on operations was unreliable. These financial reporting errors equaled about one-third of net SSD sales for fiscal year 1989. In our opinion, errors of this magnitude hinder management's ability to make effective use of SSD financial reports when evaluating the fund's financial condition, results of operations, and prices.

Errors in Accounting Entries

Our tests indicated that accounting personnel at the five ALCS made over \$173 million in errors when entering data in the stock fund trial balance reporting system. These errors were caused by a failure to (1) correct records containing duplicated inventory amounts or (2) properly compute the cost of material valued at standard prices.

The failure to make AFLC-directed correcting entries at the Warner Robins ALC caused about \$169 million in errors in ALC trial balances. Computer problems caused two inventory systems to pass duplicate data to trial balance reports. Although AFLC directed accounting personnel at all ALCS to correct the affected account balances, the accountant at the Warner Robins ALC improperly stopped making these entries in the middle of fiscal year 1989. As a result, the total value of SSD inventories reported on the trial balance was overstated.

DOD concurred with our finding and stated that many of the entries required to prepare trial balance reports are manual, and DOD stated that a large turnover in personnel created problems with manual entries. A new financial inventory accounting system is being developed; it will automate many of the trial balance updates and eliminate the potential for erroneous manual entries.

Errors in Inventory Data

Missing and erroneous inventory data caused about \$79 million in accounting errors because inaccurate quantities and prices were not identified or corrected at the source of the transaction. ALC personnel compounded the problem by adopting inconsistent or improper methods of accounting when making entries based on the data.

The most significant problem we identified was at the Warner Robins ALC, where a single pricing error caused \$70 million in reporting errors affecting inventory and revenue accounts. Air Force personnel did not detect the error until fiscal year 1990; as a result, assets and operating results were overstated for the fiscal year ending September 30, 1989.

Our tests also disclosed that reported values for inventory shipped to the Ogden ALC were abnormally high or missing for several months during fiscal year 1989, causing reporting errors of about \$9 million. Records over inventory in transit reported to the SSD accountant were poorly controlled. In one month, these amounts were overstated by about \$43 million; in another month, information was not provided in time for reporting purposes. Nevertheless, the problems were not detected and corrected by accounting personnel responsible for researching error listings before passing in-transit data to the SSD accountant. This information has a significant impact on SSD accounting since the dollar amounts are typically quite large and are used to update six different accounts in SSD trial balance reports.

Errors in Timing of Entries

We identified about \$26 million in errors resulting from not recording transactions in the appropriate reporting period. The primary causes of these errors were (1) limitations in ALC computer programs used to report values for purchases in transit and (2) improper timing of general ledger account updates made to reflect gains and losses from variances in recorded inventory values.

Our year-end tests showed over \$10 million in timing errors relating to data on material in transit from procurement. ALC accountants did not have accurate, complete, and timely information on shipments to use in accounting for material in transit. This condition affected the accuracy of entries to several accounts at the beginning and end of the year. At the Sacramento ALC, reports provided to SSD accountants at fiscal year-end contained information only through July 1989, excluding about \$2.7 million of August and September data from the year-end inventory balance. At the other ALCs, we identified an additional \$7.7 million in timing errors related to accounting for inventory items being shipped to the ALCs from procurement sources.

Other tests showed about \$16 million in errors related to the timing of accounting entries for adjustments to internal inventory records. Quarterly entries to bring the accounting system inventory account amounts into balance with supply system amounts were not timed to coincide with the quarters in a fiscal year. As a result, gains and losses reported in fiscal year 1989 SSD trial balance reports included amounts for fiscal year 1988 and excluded final entries for the end of fiscal year 1989. We identified net timing errors of \$10 million at the San Antonio ALC and \$6 million at the Warner Robins ALC.

DOD concurred with our finding and stated that the financial inventory accounting system currently under development is intended to resolve delays in recording in-transit transactions.

Surcharges Have Increased Sharply

In the past 3 years, AFLC sharply increased the surcharge added to the cost of goods sold to SSD customers from about 13 percent in fiscal year 1987 to over 20 percent in fiscal year 1989. We believe these sharp increases in SSD prices were partly caused by Air Force's need to dispose of excessive and obsolete inventories. Failure to properly bill for all SSD sales transactions also results in the need to increase prices. Higher surcharge rates increase costs to Air Force and other DOD customers. Costs associated with inefficiencies, waste, and mismanagement are passed along to the customers with the normal costs of operations. Accordingly, their appropriations may have to be increased to enable them to purchase needed items from SSD.

According to Air Force policy, new surcharge rates are set at the beginning of each fiscal year and are not changed until the following year. AFLC uses ALC trial balance data to consider the following factors to arrive at an overall surcharge rate:

- Inventory expenses: These include factors for net gains and losses from physical inventory adjustments; losses resulting from inventory shrinkage, theft, deterioration, damage, contamination, defects, and obsolescence; and adjustments to reconcile internal records.
- Price stabilization: This includes factors for inflation or deflation of suppliers' prices, refunds made to customers, and maintenance of required cash balances with Treasury.
- Transportation: This covers the cost of shipping material to customers, both within the United States and overseas.

- Inventory maintenance: This finances the acquisition of inventories required to maintain item quantities at the currently approved stock level.

According to AFLC officials responsible for stock fund accounting and surcharge calculations in fiscal year 1989, inventory expenses and price stabilization were the components primarily responsible for increases in SSD surcharge rates.

As table 4.7 shows, AFLC increased SSD surcharge rates sharply in recent years.

**Table 4.7: SSD Surcharge Rates for
Fiscal Years 1987 Through 1990**

Fiscal year	Surcharge rate (percent)
1987	13.35
1988	14.93
1989	20.36
1990	25.68

Investment Item Inventory to Be Financed by the Stock Fund

At DOD's direction, the Air Force is currently changing the way it finances repairable investment items. Prior to fiscal year 1991, the Air Force purchased repairable items with its procurement appropriations and made the items available to its operating components free of charge. In October 1990, the Air Force stock fund began to buy new repairable items and, in July 1991, it began financing the repair of such items. We recently reported that DOD was allowing the services to implement differing policies regarding the pricing and ownership of these items and that it had not developed a policy for valuing repairable items.⁷ Also, if the deficiencies and problems discussed in this chapter are not corrected, the stock fund will be unable to operate efficiently and correctly charge customers for repairable investment items. DOD stated that it will implement a policy to cover both pricing and ownership of inventories.

Inconsistent Collection Practices Produced Misleading Cash Balances

SSD cash balances reported during fiscal year 1989 were inconsistent as a result of changes made in processing stock fund billings to intentionally reduce cash collections at year-end. Because of changes in billing practices, data on collections reported from period to period were not

⁷Financial Management: Uniform Policies Needed on DOD Financing of Repairable Inventory Items (GAO/AFMD-91-40, June 21, 1991).

comparable, and the cash balance reported at fiscal year-end did not accurately reflect the results of operations. We found that a deliberate delay in billing customers in September 1989 reduced cash collections and the fiscal year-end cash balance by about \$44 million.

During fiscal year 1989, the ALCS processed collections under three different sets of instructions from AFLC. Stock fund collections were initially processed on the 3rd and 20th days of each month. In midyear, AFLC suggested that the ALCS change to the 3rd and 15th days of each month in order to speed collections and prevent a negative cash position. Finally, in the last month of the year, AFLC instructed the ALCS to bill stock fund customers only on the 3rd day of each month, consolidating the mid-month and end-of-month billing cycles. Air Force communications show that the year-end billing change was made because of a concern that cash collected in September 1989, together with a \$200 million transfer anticipated to reimburse the fund for previous losses, would have caused a cash surplus and might have been reallocated by the Secretary of the Air Force.

Weak Inventory Practices and Controls Result in Significant Unnecessary Costs

Inventory represents a significant investment of Air Force resources, and weaknesses in inventory management and controls, such as those discussed in this chapter, result in substantial unnecessary and avoidable costs to the Air Force. Internal control weaknesses and management deficiencies have undoubtedly contributed to the \$11 billion of unrequired inventory that the Air Force held as of September 30, 1990. Although our tests were not designed to measure unnecessary and avoidable costs resulting from weak inventory practices and controls, it is apparent that such costs are substantial to Air Force operations. Significant costs, such as carrying costs for storage, maintenance, and security, are incurred when unrequired inventory is acquired and retained.

Improvements in inventory management that reduce inventory growth could produce the following benefits:

- reduced capital requirements; for example, every 1 percent reduction in total Air Force inventory results in millions of dollars in reductions in capital requirements;

- savings in inventory related expenses, such as storage, distribution, security, and administrative (ordering, inspecting, etc.);
- alternative use of funds for other purposes/programs without increasing budgets; and
- improved operational efficiency.

The major objective of any inventory management system should be to maintain an optimum level of inventory—neither too high nor too low. If inventory far exceeds optimum levels, then unnecessary costs are incurred and there is an increased risk that items will become obsolete before they are used. Insufficient inventory levels create the risk that the organization will not be able to fulfill its mission. Maintaining an optimum level of inventory, including war reserves, minimizes both the investment and carrying costs associated with the inventory.

Acquisition Practices

According to a DOD inventory report, as of September 30, 1990, the Air Force held approximately \$11 billion of inventory that was unrequired for current needs. Total DOD unrequired inventory as of that date was approximately \$30 billion. We reported in March 1990⁸ that the Air Force's inventory of unrequired aircraft parts had increased at a faster rate than required stocks and that one-third of the Air Force's required inventory of aircraft parts as of 1988 was in excess of requirements for wartime or current year operations. We also reported that procurement practices, including purchasing items before they were needed and failing to terminate purchase orders which were later identified as excess to requirements, contributed to the unrequired inventory problem. Such practices lead to unnecessary or premature expenditure of scarce budgetary resources.

Unreliable perpetual records on the quantity of inventory on hand, which we found to be a significant problem in this audit, can also be a major contributing factor to excess inventories. Unreliable records lead to unsound purchasing decisions resulting in the acquisition of either too many or too few items. Buying insufficient inventory could adversely affect the ability of units to perform their missions by not having needed items in stock. Conversely, buying too many items unnecessarily consumes funds which could be used for other programs and operations, and increases the risk that items will not be used and will become obsolete. When perpetual records are unreliable to the extent demonstrated

⁸Defense Inventory: Growth in Air Force and Navy Unrequired Aircraft Parts (GAO/NSIAD-90-100, March 6, 1990).

in this audit, it can lead to excess inventories as item managers seek to avoid possible insufficient inventory levels.

Storage, Maintenance, and Security Costs

Stocking unneeded items results in substantial costs associated with storage, maintenance, and security until the items are consumed or are disposed of because they have become obsolete. Inventory items which are no longer needed should be disposed of to reduce unnecessary carrying costs. While the cost of disposal of obsolete items in itself represents a cost to the government, the one-time cost is less than maintaining the items over time.

In our February 1990 report, we recommended that the Air Force undertake a special effort to reduce its unrequired inventory. Subsequently, the Air Force instituted a program that identified over \$1.2 billion of inventory for disposal. This effort freed up over 1.5 million cubic feet of storage space and we estimate that the Air Force saved approximately \$12.4 million in annual storage costs.

Also, inadequate internal controls and inaccurate reporting of on-hand inventories, problems illustrated by this audit, increase the susceptibility to loss, theft, or waste. Strong internal controls, such as performing periodic physical inventories and investigating discrepancies between the items counted and the quantities shown in perpetual records, reduce the risk of these problems. Proper reporting of inventories raises their visibility to management, and focuses attention on any losses or abnormal transactions, including large amounts of adjustments affecting the inventory balances.

Considering just the costs of storage, maintenance, and security, as well as unknown losses from theft and waste, that would be associated with the Air Force's \$11 billion of unrequired inventory, it is clear that weak inventory practices and controls are unnecessarily costing taxpayers substantial sums annually.

Implications to the Defense Business Operations Fund

As discussed in chapter 2, DOD has implemented the Defense Business Operations Fund (DBOF), a revolving fund to eventually finance virtually all support activities in the Department, including inventory acquisition and management. We discussed the advantages of the proposed fund's

operating arrangement in testimony⁹ before the House Armed Services Committee, Subcommittee on Readiness, on April 30, 1991. However, we also cautioned against implementing DBOF until a number of concerns were addressed. The Air Force's inventory management problems and deficiencies illustrate the basis for our concerns. Principally, DOD does not currently have reliable financial management systems in place to operate DBOF as an effective and efficient business-type entity.

For example, we previously stated that in recent years SSD sharply increased the surcharges added to cost of goods sold to its customers. In our view, part of the increase was needed to cover losses which could lead to cash shortages resulting from SSD's failure to properly bill customers. Regarding DBOF, we believe that it should not be permitted to raise prices to cover such cash shortages, as is the current practice. Instead, we believe that DBOF should be required to request additional funds through the congressional appropriation process when cash shortages arise.

The rationale for our proposal is that permitting surcharges to cover past losses diminishes the incentive for DBOF to operate efficiently. As long as inefficiencies, such as those discussed with respect to SSD in the previous section, can be compensated for by simply increasing surcharges, incentives for a businesslike operation will not be present.

Until DBOF can measure the efficiency and effectiveness of its operations through a cost accounting system and reliably report results to the Congress, we believe the requirement to request additional funds from the Congress when cash levels are low would be an important part of congressional oversight. This would provide the Congress with the opportunity to review DBOF's operation, determine the reasons for the cash shortages, and evaluate the effectiveness of DOD's inventory management, including its effort to reduce excess inventories.

Conclusions

The inadequate accounting practices at the ALCs clearly fall short of the standards that will be required to meet the demands of the 1990s for better financial management. Perpetual inventory balances should be a foundation for management decisions related to inventories. However,

⁹Defense's Planned Implementation of the \$77 Billion Defense Business Operations Fund (GAO/T-AFMD-91-5, April 30, 1991).

ALC perpetual inventory records were substantially inaccurate and produced misleading inventory data for systems used in requirements computations and financial reporting. Inaccurate records have led to the development of additional internal controls which attempt to improve the quality of data used in requirements decisions. However, such additional steps do not effectively ensure accurate information for decision-making. Further, our work has consistently identified excess DOD inventories as a serious problem.

Although AFLC is responsible for 65 percent of Air Force inventory, it cannot produce an accurate dollar value for that inventory. Quantity errors, problems in accounting practices, inappropriate valuation policies for unserviceable and obsolete items, and errors in assigning prices to items have combined to significantly distort inventory values.

We believe that the problems discussed in this chapter are representative of those elsewhere in DOD and contribute significantly to unnecessary inventory costs. Considering the vast quantities of inventories that DOD holds, consumes, and purchases, we believe the unnecessary costs could be in the range of several billion dollars annually.

Previous Recommendations Still Appropriate

As previously discussed, in April 1991 we issued a report¹⁰ to the Commander, Air Force Logistics Command, which contained 18 recommendations to improve internal controls and financial reporting of inventories at the ALCS. We reaffirm the recommendations made in that report and those made in our February 1990 report.

Agency Comments and Our Evaluation

In commenting on a draft of this report, DOD generally concurred with our findings in this chapter except for stating that our inventory sampling methodology was biased and that the sample results (error rate) could not be extrapolated to the universe unless a true random sample was selected. We used dollar unit sampling which is well recognized as a valid statistical technique for measuring dollar valuations. The technique randomly selects items based on their proportional dollar sizes to that of the universe being sampled. The sample results are projectable to the universe.

DOD stated that our report “assumes” that the errors we found will not be corrected before additional items are bought. DOD further stated that

¹⁰See footnote 2, this chapter.

routine inventories, location reconciliations, and breach counts will correct many errors in perpetual records before items are purchased. We acknowledge in this chapter that, according to AFLC officials, errors in inventory records are corrected through day-to-day operations, location surveys, and physical inventories. However, our sample results indicate that 18.3 percent of perpetual records differed from what was actually on hand at four ALCs. In our opinion, this error rate indicates a significant problem with ALC inventories and seems to contradict officials' statements that errors are routinely corrected through day-to-day operations, location surveys, and physical inventories.

DOD also stated that our assertion that the costs associated with inefficiencies, waste, and mismanagement are passed to the customers along with the normal costs of operation misconstrues the purpose of the obsolescence/loss surcharge. DOD stated that the surcharge covers legitimate expenses, including inventory adjustments, losses resulting from inventory shrinkage, theft, deterioration, damage, contamination, defects, and obsolescence. DOD further stated that the main portion of the inventory obsolescence/loss surcharge pertains to the disposal of inventory and that inventory becomes excess due to changes in programs, item repairability, recoverability, and other factors that result in changes to requirements.

We agree that some inventory losses from factors such as those specified by DOD can be expected even in the most efficiently operated organizations. However, in our view, the losses incurred due to the disposal of excessive and obsolete inventory appear to significantly exceed those that could be expected as a part of normal operations. During fiscal year 1989, SSD disposed of about \$146 million of inventory. Using SSD's surcharge rate (20.36 percent) for that year, we estimated that the surcharge on fiscal year 1989 sales (\$886 million) was approximately \$150 million—about \$4 million more than the value of disposals for the year. While we recognize that changes in programs and other factors contribute to changes in inventory requirements, we also contend that maintaining 7 years of inventory, as discussed in this chapter, increases the probability that items will become obsolete and unneeded.

Internal Accounting Controls Not Adequate

The Air Force's system of internal controls was not adequate to ensure the reliability and accuracy of account balances and resulting financial reports nor to adequately control and safeguard all assets. During our reviews, we found significant internal control weaknesses—including those discussed previously in this report—resulting in material errors in the Air Force's financial reports. Specifically, we noted that (1) account balances were not always analyzed to detect errors, (2) required reconciliations of general ledger control accounts with subsidiary accounts and supporting records were not always conducted, (3) erroneous entries and adjustments were made to accounting records and not detected, and (4) controls over issuances of direct materials at the depots did not ensure that associated costs were charged to the correct jobs or that quantities issued were limited to actual job requirements. Considering the inadequacy of GAFS, as discussed in chapter 2, it is particularly important that internal control procedures be followed to ensure the integrity of accounting data and control over resources. In addition, the Air Force's report to DOD prepared pursuant to the Federal Managers' Financial Integrity Act of 1982 did not include significant internal control weaknesses identified in our 1988 and 1989 financial audits.

Air Force management is responsible for establishing and maintaining a system of internal controls in accordance with the Accounting and Auditing Act of 1950 and FMFIA. The objectives of a system of internal controls are to help provide management with reasonable, but not absolute, assurance that (1) obligations and costs are in compliance with applicable laws, (2) funds, property, and other assets are safeguarded against waste, loss, and unauthorized use or misappropriation, and (3) assets, liabilities, revenues, and expenditures applicable to agency operations are properly recorded and accounted for to permit the preparation of accounts and reliable financial and statistical reports and to maintain accountability over agency assets. Moreover, financial information is essential to building and maintaining public trust in the financial operations of the government. Effective financial management requires strong systems of internal control to help ensure the integrity of financial information, to safeguard assets, to promote conformity with proper operating procedures and to help ensure that expenditures are in accordance with congressional authorizations.

During our reviews, we found pervasive internal control weaknesses throughout the Air Force. In most cases, the Air Force had established control procedures but these procedures were not always being followed

by personnel. During this audit, we issued a number of reports and management letters to Air Force organizations regarding internal control weaknesses and recommendations for improvements. For more details on the internal control weaknesses discussed in this chapter, refer to our reports listed in appendix II. Many of the weaknesses identified in this chapter were identified in our report¹ on the results of the fiscal year 1988 financial audit of the Air Force. We reported in May 1991 that the Air Force, as of January 1991, had made only limited progress in correcting the weaknesses we previously reported.²

Account Balances Were Not Analyzed to Detect Errors

Financial information generated by any accounting system should be periodically reviewed and analyzed to ensure that errors have not occurred. Two techniques for ensuring the integrity of financial data are (1) reviewing accounts for abnormal balances and (2) analyzing trends in account balances from one period to the next. When abnormal balances and unusual or unexplainable trends in balances are noted, accounting personnel should investigate them and make necessary corrections. However, our work showed that Air Force finance staffs did not always perform these basic quality assurance procedures.

Abnormal Account Balances Were Not Investigated and Resolved

Generally, balances for specific classes of accounts carry normal or predictable balances. Asset and expense accounts, such as accounts receivable and bad debt expenses, normally carry debit balances while liabilities and revenues, such as accounts payable and sales, carry credit balances. Air Force Regulation 700-20, General Ledger and Subsidiary Accounts, provides guidance on normal balances for Air Force accounts, and Air Force Regulation 177-101 requires that Accounting and Finance Offices review and resolve abnormal balances. The existence of abnormal balances in trial balances is a strong indicator that errors have occurred in the recording or processing of transactions.

We found numerous accounts reported by Air Force organizations that had abnormal balances as of September 30, 1989. Some examples follow.

- Systems Command organizations reported credit balances for accounts receivable, advance payments, construction in progress, and general

¹Financial Audit: Air Force Does Not Effectively Account for Billions of Dollars of Resources (GAO/AFMD-90-23, February 23, 1990).

²Financial Audit: Status of Air Force Actions to Correct Deficiencies in Financial Management Systems (GAO/AFMD-91-55, May 16, 1991).

expense—even though these accounts normally carry a debit balance. Likewise, Systems Command organizations reported debit balances for accounts that should carry credit balances, such as accrued payroll, accounts payable, deposit fund liability, and unearned revenue.

- Within the United States Air Forces Europe, nine bases' trial balances for September 30, 1989, contained accounts with abnormal balances totaling \$75.6 million, including credit balances in inventory, real property, and equipment accounts. Furthermore, our review of the year-end consolidated trial balance for the Pacific Air Command revealed abnormal balances in the construction in progress and expense accounts.

Table 5.1 presents examples of abnormal (credit rather than debit) asset and expense account balances we found in year-end trial balances.

Table 5.1: Examples of Abnormal Balances Reported by Air Force Organizations in September 30, 1989, Trial Balances

Dollars in millions		
Organization	Account	Abnormal balance
Systems Command		
Electronic Systems Division	Accounts receivable—reimbursable	\$21.2
Eastern Space and Missile Center	Accounts receivable—other	20.0
Air Force Flight Test Center	Construction in progress	11.1
Electronic Systems Division	General expenses	644.7
United States Air Forces Europe		
Upper Heyford Air Base	Material on hand (supply)	52.4
Ankara Air Base	Construction in progress	7.8
Ankara Air Base	Real property (land)	1.4
Pacific Air Command		
Osan Air Base	Construction in progress	3.0
Kadena Air Base	General expenses	46.6

We advised Air Force officials of the various abnormal balances noted and, in every case they investigated, they found that the balances were erroneous. Such errors should have been detected and corrected by the Air Force organizations responsible for preparing and reviewing the trial balances. In our opinion, this was not done because of insufficient emphasis and priority placed on ensuring account balance accuracy by Air Force organizations.

DOD concurred with our finding and stated that emphasis on the accuracy of the general funds general ledger has increased by advising staff of problem areas and stressing compliance with existing requirements.

DOD stated that, among other things, it has published articles in technical bulletins and provided training on updating and maintaining general ledger accounts. DOD further stated that, as part of the Air Force's internal control review program, compliance review guides were developed and distributed to measure compliance with (1) the requirement for investigating and resolving abnormal balances and (2) other internal controls for maintaining accurate and reliable general ledgers.

Unusual Trends or Variances in Account Balances Were Not Researched

Organizations responsible for maintaining general ledgers are required by Air Force Regulation 177-101 to investigate unreasonable amounts and correct errors before finalizing trial balances. However, we found unusual trends and large variances in account balances at several locations which indicate that general ledgers were not being appropriately maintained.

Our review of 1989 trial balances for the Pacific Air Command and United States Air Forces Europe revealed (1) accounts, such as accounts payable and accrued payroll, with identical balances for fiscal years 1988 and 1989 and (2) accounts with zero or negative balances even though they normally have positive balances. For example, we found that four bases in the United States Air Forces Europe reported zero balances in construction in progress accounts even though each had ongoing construction projects. The responsible Air Force organizations had not identified these questionable balances, and, therefore, they were not researched and resolved.

Our review of the consolidated trial balance for the Air Force Systems Command revealed large variances between 1988 and 1989, as shown in table 5.2.

Table 5.2: Examples of Systems Command Consolidated Account Balances With Significant Changes From Fiscal Years 1988 to 1989

Dollars in billions			
Account	September 30, 1988	September 30, 1989	Percent change
Accounts receivable	\$0.8	\$0.3	(63)
General expense	6.1	9.3	52
Sale of services	0.5	1.1	120
Collections	0.9	1.7	89
Disbursements	8.9	13.7	54

Had Systems Command officials analyzed the variances in the general expense and disbursement accounts, they would have found that one

product division, the Space Systems Division, reported a zero balance for both accounts in its September 30, 1988, trial balance. Such a condition is not possible in an ongoing operation, yet the Systems Command accepted the zero balances without question. These fiscal year 1988 errors occurred because the Space Systems Division inadvertently reduced the balances to zero before preparing the trial balance.

In addition to large account balance variances, we found other significant variances from period to period in the accounts of organizations within the Systems Command. The most significant variance found related to the amount the Aeronautical Systems Division reported for general expenses. Although the division received \$15.7 billion, or approximately 49 percent of the Systems Command's total fiscal year 1989 appropriated funds, the division only reported \$269 million for general expenses as of September 30, 1989. This amount represented less than 3 percent of the \$9.3 billion included in the Systems Command's consolidated trial balance for general expenses. Officials of the Aeronautical Systems Division told us that their general expenses were understated by over \$13.7 billion because they had inadvertently excluded the cost of weapon systems they purchased. While these costs, according to the DOD Accounting Manual should be capitalized since they involve property that will be used over several accounting periods, the Aeronautical Systems Division treats them as expenses of each accounting period per Air Force direction. As discussed in chapter 3, the Air Force Logistics Command is responsible for valuing and reporting the weapons systems.

DOD concurred with our finding but stated that unusual trends and variances in account balances now are identified and researched. For example, DOD noted that the Air Force Systems Command now requires review of its divisional trial balances at the command level, with a report to the Comptroller on unusual trends and variances identified and the result of research and corrective actions.

Reconciliations Not Always Performed

We found that reconciliations between subsidiary records and the control accounts were not always performed to ensure the accuracy and propriety of recorded account balances. The DOD Accounting Manual and Air Force Regulation 177-101 require that reconciliations between summary and detailed records be periodically performed and documented and that adjustments, if necessary, be made promptly to bring these records into agreement. If two sets of independently derived records do not agree, management is alerted to a potential problem and can quickly

follow up to determine the reasons for the discrepancy, such as lost assets or failed procedures, and correct the errors and/or weaknesses. Reconciliation procedures require identifying, investigating, and resolving all discrepancies between general ledger control accounts and subsidiary records and making the appropriate adjustments.

Control Accounts Not Reconciled With Subsidiary Records

Our audit tests revealed that control accounts were not regularly reconciled with subsidiary accounts and with records that provide detailed support for the summary-level data recorded in control accounts. This occurred at Air Logistics Centers; Air Force Systems Command divisions; and a number of bases, including nine bases under United States Air Force of Europe. We identified and presented the following discrepancies to local officials for investigation.

- At the Sacramento Air Logistics Center, the account for progress payments to contractors was overstated by \$100 million as of September 30, 1989. The reporting error resulted from an inaccurate reconciliation of data in the Central Procurement Accounting System when compiling general ledger information.
- Nine of the 23 bases in Europe reported control accounts for certain assets, totaling \$1.1 billion, which were not supported by subsidiary accounts. The total of the subsidiary accounts differed from the total of the control accounts by approximately \$163.3 million. The subsidiary accounts were arbitrarily adjusted to match the control accounts, thus eliminating the variances.

In addition, the Air Force Systems Command did not properly reconcile its disbursement transactions with supporting records of obligations as required by Air Force regulations. Reconciliations of disbursement transactions to supporting records of obligations are essential to monitoring and controlling contractor payments and ensuring compliance with the Antideficiency Act. This act prohibits making or authorizing an obligation or expenditure in excess of the amount available in an appropriation, fund, apportionment, or the amount permitted by agency regulations (31 U.S.C. 1341 and 1517).

When a paying office makes disbursements for Systems Command product divisions, we found that the product divisions were not always reconciling disbursement transactions with their accounting records. Without these reconciliations, the Command cannot be assured that all disbursements are appropriately recorded on its contracts, and the risk

of inappropriate disbursements and inaccurate accounting reports is increased.

We also found that product divisions did not perform timely reconciliations of expenditures in manual records with automated reports referred to as "7140 reports" as required by Air Force regulations.

- At the Ballistics Systems Division, the manual records for three of the nine expenditures sampled had not been reconciled in the preceding 6 months.
- At the Aeronautical Systems Division, the manual records for 7 of the 11 expenditures sampled had not been reconciled in the preceding year.

Civilian Payroll and Personnel Master Records Not Reconciled

Three bases—Air Force District of Washington/Bolling Air Force Base, Lackland Air Force Base, and Kadena Air Base—did not compare and reconcile master payroll files with master personnel records to ensure that amounts paid were appropriate and accurate. Air Force Regulation 177-104 and Air Force Manual 30-130 require that civilian payroll and personnel data be periodically compared and reconciled to detect overpayments and payments to fictitious employees.

The Air Force District of Washington compared employee payroll and personnel records on a quarterly basis, but did not investigate or reconcile the discrepancies identified. As of September 30, 1989, there were 461 unresolved discrepancies from the July 5, 1989, comparison. The majority of the record mismatches were due to data entry errors and timing differences in updating personnel and payroll records. Although we found no improper payments, the potential for such payments existed.

Kadena Air Base compared employee payroll and personnel records at our request and found that one discrepancy involved overpayment of an employee. Base officials took action to recover the overpayment, which amounted to \$5,700. This undetected overpayment demonstrates the need to comply with the required internal control procedure to reconcile payroll and personnel records. Continued failure to do so could allow payroll fraud or abuse to go undetected.

DOD concurred with our finding and stated that in fiscal year 1990, a new automated civilian payroll system was implemented at all Air Force bases, which facilitated more effective and accurate reconciliations of payroll and personnel records. Also, DOD stated that Air Force directives

have been revised to require more stringent reconciliations and that, as part of the FMFIA review process, compliance reviews are planned to test the thoroughness and effectiveness of the new reconciliation requirements.

Controls Not Adequate to Prevent Erroneous Entries and Arbitrary Adjustments

The DOD Accounting Manual requires that documentation of transactions and other significant events, including adjustments to accounting records, be complete and accurate so that transactions and related information can be traced from their initiation, through processing, to their completion. Compliance with this standard requires that documentation be purposeful and useful to managers and auditors involved in analyzing operations. Air Force Regulation 177-101 also requires that adjustments be adequately documented.

Our 1989 audit revealed a pervasive problem throughout the Air Force with erroneous entries, arbitrary adjustments, and other errors affecting account balances. Such errors led to many of the \$116 billion of adjustments we proposed to the Air Force's fiscal year 1989 Treasury financial reports. (See chapter 2.) The following are examples of such entries/adjustments.

- At the close of fiscal year 1989, Homestead Air Force Base erroneously increased the base inventory account from \$196.2 million to \$329.9 million, resulting in an overstatement of approximately 68 percent. The accounting and finance office based this \$133.7 million adjustment on an inaccurate report from base supply, which was not questioned by accounting personnel. The inaccurate supply report and resulting erroneous inventory balance were corrected only after we brought the situation to the office's attention.
- Similarly, during year-end closing at Upper Heyford Air Base, accounting personnel recorded a \$428.6 million adjustment to the inventory on hand (supply) account, which resulted in the account having an abnormal (credit) balance of \$52.4 million. In response to our inquiry, the chief of accounts control determined that the account was credited in error. Accounts control subsequently adjusted the account to reflect a positive balance of \$376.3 million.
- At the Warner Robins ALC, we found \$490 million of accounting errors in the material in stores—other account. The account was overstated as of September 30, 1989, as a result of erroneous postings to the account during the year by accounting clerks.

Issuances of Direct Materials at Depots Not Adequately Controlled

At each of the five ALCS, AFLC operates Depot Maintenance Centers which repair and maintain equipment and weapons systems for the Air Force. The centers comprise the Depot Maintenance Service, Air Force Industrial Fund, which operates as a revolving fund by charging customers for the services provided.

At the Depot Maintenance Centers, we found that controls over the \$592 million of material costs incurred during fiscal year 1989 did not ensure that material was charged to the correct jobs. Moreover, controls were not sufficient to limit material quantity issues to actual job requirements. For example, we found that during fiscal year 1989, 61 percent of the direct material issuances at the Oklahoma City ALC exceeded standard requirements and 32 percent of the issuances exceeded maximum requirements.³

The Air Force reported the Depot Maintenance Centers' failure to limit material quantities to actual job requirements as a control weakness in its FMFIA report for fiscal year 1988. In its fiscal year 1989 report, the Air Force reported that this weakness had been corrected. However, our work showed that controls were still not sufficient to limit direct material issuances to established or actual requirements. As a result, the Depot Maintenance Centers could be issuing materials in excess of those needed for repair functions; material costs for specific jobs may not be correctly reported; and material requirement standards, which are based on historical usage data, appear to be of questionable validity.

DOD concurred with our finding and stated that the Air Force is currently developing the Depot Maintenance Management Information System which includes a module "to prevent wrong or excess material from being issued." Full implementation of this module is anticipated by September 1993.

³Standard requirements are the amounts of materials expected to be required based on engineering estimates and the history of usage for similar jobs. Maximum requirements are the amounts of material which would be required if all such material in the unit being repaired was replaced.

Air Force's FMFIA Reports Did Not Include Material Internal Control Weaknesses

The Federal Managers' Financial Integrity Act was enacted in September 1982 to strengthen internal control and accounting systems throughout the federal government and to help reduce fraud, waste, abuse, and misappropriation of federal funds. The act holds agency managers accountable for correcting noted deficiencies and requires that agencies annually identify and report internal control and accounting system problems and planned remedies. We believe that our work and that of the Air Force Audit Agency (AFAA) indicate that the Air Force is not adequately reporting material internal control weaknesses as required by FMFIA.

Section 2 of the act requires that agency systems of internal control be evaluated in accordance with OMB guidelines. The act also requires that agency heads report to the President and the Congress annually whether their systems comply with internal control standards prescribed by the Comptroller General and that

- obligations and costs are in compliance with applicable law;
- funds, property, and other assets are safeguarded against waste, loss and unauthorized use, or misappropriation; and
- revenues and expenditures applicable to agency operations are properly recorded and accounted for to permit the preparation of reliable financial and statistical reports and to maintain accountability over the assets.

Section 4 of the act further requires that agency heads include in their annual statements a separate report on whether their agencies' accounting systems conform to the Comptroller General's accounting principles, standards, and related requirements.

The Air Force, pursuant to FMFIA, reported to the Secretary of Defense for fiscal years 1988 through 1990 that its system of internal accounting and administrative control in effect during those years, taken as a whole, complied with the requirement to provide reasonable assurance that costs were in compliance with applicable law; assets were safeguarded against waste, loss, unauthorized use, or misappropriation; and revenues and expenditures were properly accounted for and recorded to permit the preparation of accounts and reliable financial and statistical reports.

In contrast, our audit of the Air Force's financial management systems in effect during fiscal year 1989 identified material internal control weaknesses as discussed in this report. As a result, we concluded that

the Air Force's internal controls and accounting systems were not sufficient to provide adequate and reliable financial information for effective management.

The Air Force's 1988, 1989, and 1990 reports did not recognize the following problems as material control weaknesses: (1) unsupported and arbitrary adjustments made to account balances and records totaling billions of dollars, (2) abnormal and unusual balances not being investigated and resolved, and (3) control accounts not being reconciled with subsidiary accounts and records. According to a DFAS, Denver Center, official,⁴ the internal control weaknesses presented in our report were considered for the 1990 FMFIA report. However, reportedly because of time constraints, the Air Force did not conduct additional reviews to evaluate the significance of the weaknesses, and, thus, they were not included in the 1990 FMFIA report. However, in commenting on a draft of our May 1991 report,⁵ the DOD Comptroller stated that the Air Force reviewed the cited deficiencies, found them not to be material, and did not include them in the fiscal year 1990 FMFIA report.

It is difficult to understand how the Air Force could conclude that the deficiencies were not material. For purposes of FMFIA, the Office of Management and Budget has described a material weakness as

"... a situation in which the designed procedures or degree of operational compliance therewith does not provide reasonable assurance that the objectives of internal control specified in the [Federal Managers' Financial Integrity] Act are being accomplished."

In our view, the internal control weaknesses discussed in this and our previous reports preclude the Air Force from having reasonable assurance that internal accounting control objectives are being met. In our opinion, the weaknesses meet the Office of Management and Budget's definition of material weaknesses.

AFAA reviewed the Air Force's implementation of FMFIA for fiscal years 1988 and 1989 and raised serious concerns about the validity of the Air Force's assertions. In 1988, AFAA reported that the accounting system review program did not provide management an adequate basis for determining whether Air Force accounting systems were in conformance

⁴As discussed in chapter 1, the Air Force Accounting and Finance Center is now a component of the Defense Finance and Accounting Service and is known as DFAS, Denver Center.

⁵See footnote 2, this chapter.

with appropriate accounting principles and standards. According to the audit agency, the major problem was that system managers were not effectively implementing established procedures.⁶

In its 1989 review, AFAA raised concerns that there was a lack of assurance that internal control reviews performed by managers were sufficient to ensure the adequacy of controls and safeguarding of assets. AFAA noted that 22 of the 23 material internal control weaknesses addressed in the fiscal year 1989 report were identified by sources external to the affected organizations, and 19 of these weaknesses were in areas that management had rated "low risk."

Conclusions

We found pervasive internal control weaknesses throughout the Air Force similar to the problems identified in our fiscal year 1988 financial audit. Generally, the Air Force internal control weaknesses resulted from failure to follow established procedures, such as reviewing accounts for abnormal balances and reconciling control accounts with subsidiary accounts and supporting records. Also, significant weaknesses were not reported in the Air Force's FMFIA reports for fiscal years 1988 through 1990. Internal control evaluations performed pursuant to FMFIA provide an excellent vehicle for identifying and correcting internal control weaknesses. By not acknowledging and reporting the weaknesses, the Air Force is not in a position to remedy them. In addition, the spirit and intent of FMFIA is violated by reporting primarily those weaknesses which are disclosed by audit organizations.

Previous Recommendations Still Appropriate

In our February 1990 report, we made several recommendations to strengthen internal controls and reporting pursuant to FMFIA. Specifically, we recommended that the Secretary of the Air Force direct the Chief Financial Officer to

- report the internal control problems with reconciliations and documentation for adjustments in FMFIA reports to the Secretary of Defense;
- reconcile disbursements with obligations and promptly correct errors;
- document all adjustments to subsidiary records and control accounts;
- enforce the Air Force's requirement that supervisors and managers review and approve all significant adjustments; and
- report unsupported adjustments and reconciliation internal control problems, if applicable, in future FMFIA reports.

⁶AFAA Report of Audit, Evaluation of Air Force Accounting Systems Review Program—Fiscal Year 1988, July 21, 1989.

The DOD Comptroller concurred with all of these recommendations. We reported in May 1991 that the Air Force had made some progress in implementing its planned interim corrective actions. Generally, the Air Force had reviewed its pertinent regulations and guidances relating to internal control procedures and issued some communications to managers clarifying certain procedures and stressing regulatory requirements and the need for and importance of adequate controls and documentation. However, the Air Force had not met all of its planned milestones and, as discussed in this chapter, did not include certain material weaknesses in its fiscal year 1989 and 1990 FMFIA reports to the Secretary of Defense which we believe should have been reported.

Therefore, we reaffirm the above recommendations and are making no additional recommendations.

Agency Comments and Our Evaluation

In commenting on a draft of this report, DOD generally concurred with our findings. However, DOD stated that Air Force programs for identifying material internal control weaknesses and nonconformance with federal accounting requirements for FMFIA reporting were designed to meet legislative and OMB requirements. DOD stated that the weaknesses we reported were considered for FMFIA reporting in fiscal year 1990 but the extent and materiality of the weaknesses were not factually established. DOD further stated that as part of the fiscal year 1991 internal control review program, the weaknesses identified in this report were specifically included and determinations based on materiality will be made on the results of the program. DOD noted that the Air Force has reported GAFS as a noncompliant system in section 4 of its FMFIA reports.

As discussed in chapter 2, pursuant to section 4 of FMFIA, the Air Force has for a number of years reported that GAFS did not comply with federal standards. However, the majority of the internal control weaknesses discussed in this chapter were not the result of GAFS design deficiencies but rather the failure of Air Force personnel to follow prescribed policies and procedures. In our view, a reasonable and impartial evaluation of the internal control weaknesses we identified could only conclude that they represent material weaknesses and require full disclosure in the Air Force's FMFIA reports. Considering the seriousness of the weaknesses we identified, we question whether the Air Force has adequate assurance regarding the effectiveness of its systems internal controls.

Short-Term Actions Needed to Improve Quality of Financial Data and Ensure Successful Completion of Financial Statement Audit

As discussed in our February 1990 report and the previous chapters of this report, serious problems exist with the Air Force's financial management systems and internal control structure which prevent the accumulation and reporting of reliable financial information. Air Force and DOD managers, along with the Congress, need reliable financial data in order to make informed decisions regarding Air Force's operations and programs. In response to the 26 recommendations contained in our February 1990 report, the DOD Comptroller cited the Corporate Information Management (CIM) initiative as being wholly or partly responsive to implementing corrective actions for 17 recommendations. While the CIM initiative is a promising undertaking, improved systems resulting from the initiative will not be implemented for years, thereby necessitating the need for shorter term actions to enhance existing systems and practices. Despite the limitations and deficiencies of the existing systems, much can be done by the Air Force and DFAS to improve the quality of the financial information these systems produce.

While DOD has placed substantial emphasis on CIM for correcting the problems we have reported in this and other reports, aggressive actions are needed to achieve improvements now. To illustrate, more scrupulous adherence to established internal control procedures, establishing more reasonable valuations for weapons systems, and improving accounting for and controls over inventories would result in more accurate and reliable financial data. These can be accomplished currently, independent of the CIM initiative.

DFAS, Denver Center, the hub of Air Force financial management operations, is responsible for preparing the Air Force's financial reports and statements. However, the accuracy and reliability of such reports and statements depend largely on corrective actions being implemented within Air Force organizations to resolve the deficiencies we have reported.

As previously noted, the CFO Act requires that the Air Force, as part of a pilot project involving 10 agencies, prepare agencywide financial statements for fiscal year 1992 and have them audited. The law provides that the DOD Inspector General, or an independent external auditor determined by the DOD Inspector General, report on the reliability of the financial statements by June 30 of the following year. The DOD Inspector General has designated the Air Force Audit Agency (AFAA) to conduct the audit.

Conducting financial audits of organizations the size and complexity of the Air Force also requires detailed planning, substantial resources, and organizational commitment by the auditor. Generally accepted government auditing standards (GAGAS)¹ and American Institute of Certified Public Accountants (AICPA) standards establish the parameters and requirements for such audits. Although the DOD Inspector General has designated AFSA to conduct the fiscal year 1992 Air Force financial audit, under the CFO Act, the responsibility for ensuring that the audit is conducted in accordance with professional standards and reporting on its results remain with the DOD Inspector General.

Financial Improvement Strategies Need More Emphasis on Short- Range Objectives

While DOD and the Air Force are primarily relying on the CIM initiative to provide long-term solutions to Air Force's financial management problems, shorter term actions can yield substantial benefits, both in the near term and long term. We reported in May 1991 that only limited progress had been made in implementing corrective actions for our previous recommendations. However, more emphasis on immediate actions can improve the quality of Air Force's current financial information and maximize the reliability of data provided to any future systems developed under the CIM effort.

Limited Progress Made in Implementing Corrective Actions

In our February 1990 report, we made 26 recommendations for improving the Air Force's financial systems, internal controls and accounting and financial information. The Air Force provided us with an action plan in August 1990 which addressed, either directly or indirectly, most of the recommendations. Primarily, the Air Force plan represented interim "fixes" to many of the problems we reported until permanent solutions are instituted as a result of Defense Management Review (DMR) initiatives, primarily CIM. In May 1991, we reported² on the status of the Air Force's interim actions and found that it had made only limited progress in addressing the deficiencies we previously reported.

In our May 1991 report, we noted that as of January 1991, many of the Air Force's interim actions were behind schedule. In our view, the Air Force has not sufficiently emphasized correcting the deficiencies we reported. Although DOD envisions that the CIM initiative will resolve

¹The Comptroller General's Government Auditing Standards (1988 revision), commonly referred to as the "yellow book."

²Financial Audit: Status of Air Force Actions to Correct Deficiencies in Financial Management Systems (GAO/AFMD-91-55, May 16, 1991).

many of the problems we reported, this initiative will not be completed for years, while there is a critical need now for good internal controls and reasonably accurate financial information. Accordingly, the Air Force and DFAS, Denver Center, still need to aggressively pursue efforts to make short-term improvements in internal controls and the quality of financial data in existing systems. As discussed in this report, many of the problems can readily be resolved with more stringent compliance with existing Air Force procedures and policies. Absent such action, the Air Force, as was the case in 1988, will not be able to produce auditable financial statements for fiscal year 1992. Equally important, until meaningful corrective actions are accomplished, effective management of Air Force activities and resources may be impaired.

DOD initiated CIM in October 1989. CIM's objectives include (1) implementing new or improved business methods through the use of modern automated systems and creating more uniform practices for common functions and (2) improving the standardization, quality, and consistency of data from DOD's multiple automated information systems. CIM is intended to eliminate or reduce duplicate systems that perform the same functions. In light of DOD's long-established business practices and hundreds of existing information systems supporting these practices, accomplishing CIM's long-term goals will require many years—perhaps a decade. Therefore, satisfying DOD's financial information needs necessitates both a long-term and near-term implementation strategy.

We recently issued two reports and presented testimony³ which address this important initiative. Generally, we found that DOD has encountered difficulties in the early stages of the CIM initiative. Organizational stability was lacking, including problems with establishing organizational responsibility for the project and developing a strategy for systems standardization.

Maximizing Reliability of Existing Systems and Processes Key to Long-Range Improvements

Long-range improvements in financial management systems and the quality of financial information must begin with concerted efforts to improve existing systems and information. Data contained in existing systems will be entered into any new systems developed and implemented as a result of the CIM initiative. If inaccurate and unreliable data are entered into new systems, then a primary purpose—increased

³Defense ADP: Corporate Information Management Savings Estimates Are Not Supported (GAO/IMTEC-91-18, February 22, 1991); Defense ADP: Corporate Information Management Initiative Faces Significant Challenges (GAO/IMTEC-91-35, April 22, 1991); and Challenges Facing Defense's Corporate Information Management Initiative (GAO/T-IMTEC-91-10, April 23, 1991).

reliability—for the new systems is defeated. Therefore, efforts are needed to improve the quality of Air Force's current financial information.

Many of the deficiencies with Air Force's financial information can be resolved, or at least vastly improved, without new systems. Many of the problems we have reported result from Air Force organizations' failure to follow established procedures and regulations. Also, more reliable information can be developed from existing sources, such as the budgetary systems.

Our audits have identified the primary problems with Air Force financial systems. The audit process can be extremely useful in identifying problems and developing solutions. However, for the audit process to be as effective as possible, management must be responsive and proactive in its efforts to implement solutions.

In fiscal year 1992, the Air Force will undergo a third financial audit—one required by the CFO Act. The success of that audit and, more importantly, longer-range improvements in financial management necessitates that DFAS, Denver Center, and Air Force management

- comply with existing DOD and Air Force accounting policies and procedures, which includes ensuring that the effects of budgetary transactions are accurately reflected in proprietary accounts (chapter 2);
- develop reasonable costs and valuations for weapons systems (chapter 3);
- strengthen management of, controls over, and accounting for inventories (chapter 4); and
- achieve compliance with established internal control procedures (chapter 5).

DFAS, Denver Center, Is Responsible for Preparing Air Force Financial Statements

DFAS, Denver Center, is tasked to prepare accurate, reliable, and timely Air Force financial reports and statements as required by executive branch financial reporting requirements. In this and our February 1990 report, we discussed weaknesses and deficiencies in Air Force internal controls and financial operations that adversely affect financial management and preclude reliable financial reporting. Although the Air Force's fiscal year 1988 financial statements were determined to be unauditably, in our view, the Air Force nevertheless made progress in improving its financial discipline by endeavoring to prepare those statements. For example, the finance center developed computer programs to

extract expense amounts from budgetary data bases for more accurate financial reporting. The finance center also implemented methodologies to more efficiently compile data for financial statements and reports.

DFAS, Denver Center, as the hub of financial activity for the Air Force, will necessarily have to ensure that the progress made in the 1988 effort is utilized and built upon as it endeavors to prepare financial statements required by the CFO Act. While the form and content of financial statements will be established by the Office of Management and Budget, we believe that DFAS, Denver Center, should utilize the methodologies and procedures developed for the 1988 statements to prepare future statements. For example, the finance center developed procedures to (1) generate detailed expense data from the budgetary system and (2) identify intra-agency balances to be eliminated.

DFAS, Denver Center, will also have to ensure that financial data reported by Air Force organizations is more reliable than similar data reported in the past. For example, the center will need to ensure the reasonableness of data submitted by Air Force organizations. This entails evaluating the submissions to determine, among other things, (1) the completeness of data, (2) that abnormal or illogical balances are not present or, if present, are satisfactorily investigated and resolved, and (3) that unusual balance fluctuations are investigated and explained.

We understand that since our May 1991 report, DFAS, Denver Center, has increased its emphasis for accomplishing corrective actions. Also, we understand that DFAS, Denver Center, has established a group to coordinate actions within the Air Force and DFAS to deal with the problems that adversely affect the preparation of reliable financial statements for fiscal year 1992. We believe that such a group, if properly managed, can be beneficial because many of the problems we have identified, such as weapons systems valuations and inventory accuracy are the primary responsibilities of logistics and other operational organizations.

DOD Inspector General Responsible for Fiscal Year 1992 Air Force Financial Statement Audit

The CFO Act provides that the DOD Inspector General or an independent auditor, as determined by the DOD Inspector General, report on the Air Force's fiscal year 1992 financial statements. The objectives of a financial statement audit are to determine whether (1) the financial statements present fairly the financial position, results of operations, and cash flows or changes in financial position in accordance with generally accepted accounting principles, (2) the entity has complied with laws and regulations for those transactions and events that may have a material effect on the financial statements, and (3) the entity's internal control structure provides reasonable assurance that control objectives are achieved. In conducting an audit in accordance with GAGAS, the auditor is required to plan and conduct sufficient tests to satisfy these objectives.

The financial audit of the Air Force's fiscal year 1992 statements, mandated by the CFO Act, will be a difficult undertaking not only because of the Air Force's size and complexity, but also because of the many unresolved problems with its financial and accounting systems discussed in this report. Also, an audit of this nature will be a first-time endeavor by the AFMAA, which has been designated by the DOD Inspector General to conduct the audit, and will require substantial advance preparation in order to be completed in a timely manner. Although the DOD Inspector General may designate another organization to conduct the Air Force audit under the CFO Act, the DOD Inspector General is still responsible for ensuring that the audit is conducted in accordance with applicable standards and for reporting the results of the audit.

Conclusions

Developing auditable financial statements in accordance with generally accepted accounting principles requires substantial commitment by the Air Force and DFAS, Denver Center. In our February 1990 report, we made 26 recommendations for improving the Air Force's accounting and financial information. However, many of DOD's proposed solutions in response to our recommendations were of a long-term nature, and the interim actions planned by the Air Force were behind schedule. Aggressive actions are needed to implement solutions for the problems we have presented in this and other reports so that the 1992 financial statements can be accurately prepared and audited in accordance with applicable standards.

To effectively carry out its mandate as established by the CFO Act, the DOD Inspector General has a major role in ensuring that AFMAA adequately

plans for the Air Force audit, including training its staff and formulating an audit approach. Considering the Air Force's size and complexity, unresolved problems with accounting systems, and the fact that this will be a first-time endeavor by the DOD Inspector General and AFAA, the fiscal year 1992 audit will be a major challenge. With careful planning and early preparation, the auditors can anticipate problems and find alternative solutions to ensure that the audit meets its objectives in an efficient manner.

Agency Comments and Our Evaluation

DOD agreed that both near-term and long-term financial management improvement strategies are needed. Regarding short-term efforts, DOD stated the following.

- Considerable progress has been made in improving Air Force general ledger accounting and that actions have been implemented to resolve the reported problems.
- DFAS has directed Air Force field offices to comply with existing requirements and provided explanatory articles to reinforce the requirements.
- Training has been provided on general ledger accounting and more emphasis placed on the need for reliable financial reporting.

Lack of compliance with existing policies, procedures, and requirements resulted in many of the problems we noted. Issuing guidance, clarifying procedures, and providing training are intermediate actions which can lead to favorable results. Many of the actions referred to by DOD would have been implemented after we completed our work and, based on DOD's description, could yield positive results if sustained over time. While we recognize that efforts to correct deficiencies may have accelerated since we completed our audit work, the success of such efforts can be assessed only by future audits or evaluations.

Air Force's Fiscal Year 1989 Treasury Financial Reports: Original and Revised Submissions

During our fiscal year 1989 audit, we identified billions of dollars of errors in the Air Force's annual Treasury financial reports. After we informed Air Force of the errors, officials recalled the reports, made approximately \$62 billion of corrections, and submitted the revised reports to the Department of the Treasury. Tables I.1 and I.2 present the Air Force's original and revised consolidated reports on financial position and operations.

Table I.1: Consolidated Report on Financial Position

Dollars in millions			
Assets	Original amount	Revised amount	Amount of revision
Fund balance with Treasury and cash			
Fund balance(s)	\$79,468	\$79,523	\$55
Cash	29	29	0
Accounts receivable			
Federal agencies			
Current	2,114	1,024	(1,090)
Public			
Current	439	600	161
Noncurrent	148	148	0
Less allowances	(7)	(7)	0
Advances and prepayments			
Federal agencies	49	4	(45)
Public	319	319	0
Inventories			
Operating consumables	78,792	61,659	(17,133)
Product or service components	381	1,038	657
Stockpiled materials	0	1,009	1,009
Other	29	29	0
Property, plant, and equipment			
Structures, facilities, and leasehold improvements	31,109	31,261	152
Military equipment	103,348	104,355	1,007
ADP software	0	22	22
Equipment	25,010	27,821	2,811
Construction in progress	1,668	17,070	15,402
Land	217	224	7
Less allowances	(973)	(973)	0
Other assets	1	7	6
Total Assets	\$322,141	\$325,162	\$3,021

Appendix I
Air Force's Fiscal Year 1989 Treasury
Financial Reports: Original and
Revised Submissions

	Original amount	Revised amount	Amount of revision
Liabilities			
Accounts payable			
Federal agencies	\$4,721	\$659	\$(4,062)
Public	12,471	11,369	(1,102)
Accrued payroll and benefits	689	745	56
Accrued unfunded annual leave	622	2,529	1,907
Unearned revenue (advances)			
Federal agencies	4	4	0
Public	176	176	0
Deposit funds	346	346	0
Other liabilities	384	2,200	1,816
Total Liabilities	\$19,413	\$18,028	\$(1,385)
Equity			
Unexpended financed budget authority			
Unexpended appropriations	\$65,544	\$65,599	\$55
Less unfilled customer orders	(1,398)	(1,398)	0
Invested capital	227,305	231,743	4,438
Revolving fund balances			
Appropriated capital	4,693	4,693	0
Cumulative results	4,597	4,510	(87)
Donations	1,513	1,513	0
Trust fund balances	474	474	0
Total Equity	\$302,728	\$307,134	\$4,406
Total Liabilities and Equity	\$322,141	\$325,162	\$3,021

Appendix I
Air Force's Fiscal Year 1989 Treasury
Financial Reports: Original and
Revised Submissions

Table I.2: Consolidated Report on
Operations

Dollars in millions			
	Original amount	Revised amount	Amount of revision
Financing sources			
Accrued expenditures	\$91,904	\$91,904	\$0
Revenue			
Federal sources	15,673	2,961	(12,712)
Public sources	4,231	4,231	0
Other	10	1,005	995
Total financing sources	\$111,818	\$100,101	\$(11,717)
Operating expenses			
Cost of goods sold	\$14,538	\$14,414	\$(124)
Operating/program expenses, funded	96,918	81,728	(15,190)
Unfunded expenses	0	1,007	1,007
Total operating expenses	\$111,456	\$97,149	\$(14,307)
Net results before adjustments	362	2,952	2,590
Less capital expenditures	0	(2,578)	(2,578)
Less extraordinary items	12	0	(12)
Net Results	\$374	\$374	\$0

GAO Reports Issued as a Result of the Fiscal Year 1989 Air Force Audit

As part of our fiscal year 1989 financial audit, we issued a number of reports to various Air Force entities. These reports disclosed problems and deficiencies identified during our work at the entities and contained recommendations for corrective actions. These previously issued reports support the findings presented in this report.

Report number	Title	Date issued
GAO/AFMD-91-22	Financial Audit: Financial Reporting and Internal Controls at the Air Force Systems Command	January 23, 1991
GAO/AFMD-91-26	Financial Audit: Air Force's Base-Level Financial Systems Do Not Provide Reliable Information	January 31, 1991
GAO/AFMD-91-34	Financial Audit: Financial Reporting and Internal Controls at the Air Logistics Centers	April 5, 1991
GAO/AFMD-91-55	Financial Audit: Status of Air Force Actions to Correct Deficiencies in Financial Management Systems	May 16, 1991
GAO/AFMD-90-74ML	Management Letter to Commander, Offutt Air Force Base, Nebraska	May 23, 1990
GAO/AFMD-90-96ML	Management Letter to Commander, Air Force District of Washington, Bolling Air Force Base	July 24, 1990
GAO/AFMD-90-103ML	Management Letter to Deputy Chief of Staff (Comptroller) Headquarters, United States Air Forces in Europe	October 22, 1990
GAO/AFMD-90-104ML	Management Letter to the Commander, 20th Tactical Fighter Wing, Upper Heyford, United Kingdom	September 7, 1990
GAO/AFMD-90-106ML	Management Letter to the Commander, 316th Air Division, Ramstein Air Base, Republic of Germany	September 7, 1990
GAO/AFMD-90-109ML	Management Letter to the Commander, Air Force Accounting and Finance Center	July 20, 1990
GAO/AFMD-91-33ML	Management Letter to the Commander, Air Force Logistics Command	February 26, 1991
GAO/AFMD-92-5ML	Management Letter to the Comptroller, Department of Defense	October 22, 1991

Locations Where Audit Work Was Conducted

During our fiscal year 1989 audit, we conducted fieldwork at the following locations:

- Air Force headquarters, Pentagon, Washington, D.C.;
- Air Force Accounting and Finance Center (now DFAS, Denver Center), Lowry Air Force Base, Denver, Colorado;
- Air Force Systems Command (AFSC) headquarters, Andrews Air Force Base, Maryland;
- Aeronautical Systems Division, AFSC, Wright-Patterson Air Force Base, Ohio;
- Space Systems Division, AFSC, Los Angeles Air Force Station, California;
- Ballistics Systems Division, AFSC, Norton Air Force Base, California;
- General Electric Corporation, Evendale, Ohio;
- Hughes Aircraft Company, El Segundo, California;
- Rockwell International, Anaheim, California;
- Ogden Air Logistics Center, Hill Air Force Base, Utah;
- San Antonio Air Logistics Center, Kelly Air Force Base, Texas;
- Warner Robins Air Logistics Center, Robins Air Force Base, Georgia;
- Sacramento Air Logistics Center, McClellan Air Force Base, California;
- Oklahoma City Air Logistics Center, Tinker Air Force Base, Oklahoma;
- Homestead Air Force Base, Florida;
- Pacific Air Forces headquarters, Hickam Air Force Base, Hawaii;
- Hickam Air Force Base, Hawaii;
- Kadena Air Base, Japan;
- United States Air Forces in Europe, Ramstein Air Base, West Germany;
- Upper Heyford Air Base, England;
- Ramstein Air Base, West Germany;
- Offutt Air Force Base, Nebraska;
- Langley Air Force Base, Virginia;
- Lackland Air Force Base, Texas;
- Andrews Air Force Base, Maryland;
- Air Force District of Washington, Bolling Air Force Base, Washington, D.C.; and
- Military Airlift Command headquarters, Scott Air Force Base, Illinois.

Excerpts From the Department of Defense's Comments

Note: GAO comments supplementing those in the report text appear at the end of this appendix.



OFFICE OF THE COMPTROLLER OF THE DEPARTMENT OF DEFENSE

WASHINGTON, DC 20301-1100

(Management Systems)

OCT 31 1991

Mr. Donald H. Chapin
Assistant Comptroller General
Accounting and Financial
Management Division
U.S. General Accounting Office
Washington, D.C. 20548

Dear Mr. Chapin:

This is the Department of Defense (DoD) response to the General Accounting Office (GAO) Draft Report, "FINANCIAL AUDIT: Aggressive Actions Needed for Air Force to Meet Objectives of the CFO Act," dated August 30, 1991 (GAO Code 917119/OSD Case 8376-L). With minor exceptions, the DoD generally concurs with the GAO findings and recommendations.

The Department has taken action, or actions are planned, to address the internal control weaknesses over Government assets and inaccurate reporting of general ledger account balances addressed in the report. The Air Force currently has Federal Managers' Financial Integrity Act internal control review processes in place. Those reconciliation and adjustment issues deemed to be material will be considered by the Air Force for reporting to the Secretary of Defense.

The Department is committed to improving the quality, efficiency, and effectiveness of all DoD financial operations. Additionally, the Department supports the Chief Financial Officers Act of 1990, and its provisions requiring the preparation and audit of financial statements.

The detailed DoD comments on the various report findings and recommendations are provided in the enclosures.

Sincerely,

A handwritten signature in dark ink, appearing to read "Alvin Tucker", is written over a horizontal line.

Alvin Tucker
Deputy Comptroller
(Management Systems)

Enclosures

See comment 1.

GAO DRAFT REPORT - DATED AUGUST 30, 1991
(GAO CODE 917119) OSD CASE 8376-L

"FINANCIAL AUDIT: AGGRESSIVE ACTIONS NEEDED FOR
AIR FORCE TO MEET OBJECTIVES OF THE CFO ACT"

DEPARTMENT OF DEFENSE COMMENTS

CHAPTER 1: INTRODUCTION

[Text omitted.]

CHAPTER 2: NONINTEGRATED FINANCIAL SYSTEMS
GENERATE UNRELIABLE INFORMATION

- o FINDING A: Information Produced by Accounting System is Unreliable: Financial Structure Not Integrated. The GAO reported that Title 2 of the GAO Manual, Policy and Procedures Manual for Guidance of Federal Agencies, states that the accounting system of an agency must be an integral part of the total financial management structure. The GAO Manual further states that agency accounting systems must (1) provide sufficient discipline and effective internal control over operations to protect appropriated funds, cash, and other resources from fraud, waste, and mismanagement, and (2) produce reliable and useful information on the results of operations. The GAO explained that a general ledger, which includes all necessary proprietary accounts, serves as an integral part of an agency financial management system and as an essential control mechanism, by summarizing all of the financial data for top management and decisionmakers.

The GAO observed that Office of Management and Budget Circular A-127, Financial Management Systems, requires agencies to establish and maintain a single, integrated financial management system, which may be supplemented by subsidiary systems. According to the GAO, such systems are required to comply with applicable budget and accounting principles and standards and Treasury reporting

requirements, and to produce financial data that are complete, accurate, and verifiable--and developed from official records and systems.

The GAO stressed that integrated, well controlled financial management systems help ensure that overall financial management operations and activities will be strengthened. The GAO observed that the integration of budgeting and accounting provides a record of historical costs and performance data that is key to estimating future cost. The GAO further stressed that, by integrating budgetary and accounting systems, controls can be established to ensure that assets acquired with budgetary resources are accounted for and controlled by the accounting system--i.e., the general ledger system.

The GAO again referenced its February 1990 report (OSD Case 8193-A), which pointed out that the General Accounting and Finance System was intended to serve as the Air Force general ledger. The GAO found, however, that the system was not implemented in a manner, which would permit it to record, process, summarize, and report financial results for Air Force activities. The GAO concluded that the effect of budgetary transactions are not recorded in system accurately and property, and the system must rely on feeder or property systems for a number of balances.

See comment 2.

DoD RESPONSE: Partially concur. The description of Office of Management and Budget and other requirements for financial management and accounting systems of Federal organizations is accurate. However, the GAO characterization (in this finding and throughout the report) of the Air Force General Accounting and Finance System as solely a general ledger accounting system that is separate and apart from other financial management systems is not accurate. The General Accounting and Finance System is the basic fund control, status of funds, and cash accountability system of the Air Force that is used for financial management, and is the authoritative source for budget execution and other financial reporting to the Treasury, the Office of Management and Budget, and others. The General Accounting and Finance System performs those functions well, as the GAO stated in its prior report. The General Accounting and Finance System integrates and reports general funds data vertically as the basic system for base and command levels. The system also integrates data horizontally to produce general ledger and other information. The system is not a transaction driven general ledger based system, and that has been long recognized by the Air Force and the DoD in annual Federal Managers' Financial Integrity Act certifications. The General Accounting and Finance System is reliant on data

from other systems to produce some general ledger information. The report, as written, would lead the reader to erroneous conclusions about the overall reliability of the General Accounting and Finance System and the scope of the problem areas where improvements are needed.

[Text omitted.]

- o **FINDING F: Billions of Dollars of Errors Noted in Annual Treasury Financial Reports.** The GAO reported that the Air Force did not prepare consolidated financial statements for FY 1989 in accordance with generally accepted accounting principles. The GAO reported that, instead, the Air Force issued the annual financial reports required by the Department of the Treasury. The GAO identified tens of billions of dollars of adjustments that were needed to improve the accuracy of the reports and the underlying records from which they were developed.

The GAO explained the Department of the Treasury, under I TFM 2-4100, requires that Federal agencies annually prepare and submit to Treasury timely and reliable financial reports which fully disclose the financial results of all programs and activities. According to the GAO, the Treasury uses the agency reports to prepare consolidated Government-wide financial reports, which provide information to the Congress and to the public about overall Government performance and stewardship. The GAO indicated that consolidated Federal financial statements should provide the Congress and the Administration with information for determining the implications and consequences of fiscal and economic policy decisions. The GAO reported that, if the data in the reports are inaccurate, any analyses performed by users would likewise be of questionable value.

In July 1990, the GAO issued a report to the Commander of the Air Force Accounting and Finance Center (now the Defense Finance and Accounting Service, Denver Center) OSD Case 8376-A, which suggested over \$116 billion of adjustments to the FY 1989 Air Force Treasury financial reports. According to the GAO, the net effect of the proposed adjustments would have been decreases of \$50.4 billion to assets, \$1.4 billion to liabilities, \$8.0 billion to revenues, and \$10.6 billion to expenses. The GAO maintained that the suggested adjustments were needed to (1) correct errors identified in base-level and command-level trial balances and other financial reports, which were transmitted to the finance center and included

in the Treasury financial reports and (2) eliminate intra-agency balances and correct errors made at the finance center in preparing the reports. The GAO explained that the proposed adjustments included approximately \$57 billion to record depreciation on certain general fund assets, such as buildings and aircraft, in order to report the Air Force costs of operations more accurately.

The GAO pointed out that the Air Force recalled and revised the financial reports and recorded approximately \$62 billion of the suggested adjustments. According to the GAO, the Air Force declined to make adjustments to record depreciation on its general fund assets. The GAO stated that, according to Air Force officials, Executive Branch financial reporting standards do not require depreciation on such assets. It is the GAO position that, while current standards do not require agencies to depreciate general fund assets, agencies should nonetheless record depreciation in order to provide more accurate information on the costs of operations. The GAO reported that the Air Force submitted the revised reports to Treasury in October 1990.

See comment 3.

DoD RESPONSE: Partially concur. The report implies that the conditions noted in 1989 still exist in the Air Force and the Defense Finance and Accounting Center. Beginning in FY 1990, considerable progress was made towards improving the accuracy of air Force financial reports. The Defense Finance and Accounting Service-Denver updated the year-end directives and procedures to ensure that all necessary eliminating entries are accomplished. The late report from the field was an isolated incident from a single activity. The Treasury Department has extended the report due date for the financial statements, so late reports should not be a problem in the future. The accounting error reclassifications were mainly in the area between construction in progress and inventory. Guidance has been sent to the field providing direction, and emphasizing the need for accurate general ledger accounting and reporting. Depreciation is a complex issue. The Subcommittee on Audited Financial Statements of the Systems and Information Committee of the Chief Financial Officer Council has extensively reviewed the depreciation of general Government assets and could not come to a conclusion. Therefore, they recommended the issue be forwarded to the Financial Accounting and Standards Board for further study. Meanwhile, the Subcommittee recommended that the current requirements be followed. The Defense Finance and Accounting Service-Denver Center, implemented all the departmental "short-term fixes" that were identified to improve the accuracy and reliability of Air Force financial information.

[Text omitted.]

**CHAPTER 3: REPORTED COSTS OF WEAPONS SYSTEMS
ARE UNRELIABLE**

[Text omitted.]

- o **RECOMMENDATION 2:** The GAO recommended that the Secretary of Defense direct the Comptroller, DoD to develop procedures for establishing values for older systems by appraisal or another reasonable basis.

DOD RESPONSE: Partially concur. The Department considered establishing values for older equipment and weapons systems by the use of appraisal. It has been determined, however, that such a process would be overly expensive and time-consuming in relationship to the anticipated benefit. However, when such information is readily available, the Department will consider the use of such information when preparing the Air Force financial statements.

**CHAPTER 4: ACCOUNTING AND CONTROLS OVER
ALC INVENTORIES ARE INADEQUATE**

[Text omitted.]

- o **FINDING C: Physical Inventories Disclosed Inaccurate Perpetual Inventory Records.** Based on a statistical sample of 1,771 investment items valued at \$1.83 billion, the GAO estimated that 18.3 percent of the perpetual inventory records differed from what was actually in the inventory as of September 30, 1989. The GAO projected that the sum total of all errors in the perpetual inventory records to be about \$2.3 billion--\$1.5 billion overstated and \$.8 billion understated, for a net over-statement of about \$.7 billion.

The GAO reported Air Logistics Center officials recognized that the perpetual inventory records had been chronically inaccurate over the years. The GAO observed that, in an attempt to compensate for the situation, Material Management Directorate managers developed additional procedures to increase the accuracy of data used in the requirements determination process. The GAO cited an example where the item managers use information from the

See comment 4.

stock control and distribution system to provide supplementary data on inventory balances, but noted managers can be assured of accurate data only by a confirming physical count. The GAO was advised that item managers often request special physical inventories to ensure that accurate amounts are used when making requirements computations for high-dollar or critical items.

According to the GAO, Air Force officials acknowledged the possibility of inappropriate procurements due to inaccurate inventory records, but emphasized that procedures exist to prevent errors in the requirements process. The GAO was advised that many of the variances in inventory balances are corrected through day-to-day supply operations such as location surveys, location reconciliations, and the ongoing physical inventory process.

DOD RESPONSE: Partially concur. The Department agrees that there are inaccurate perpetual inventory records. The DoD disagrees, however, on the magnitude and effect of the inaccurate records. The GAO selected a biased statistical sample of only high dollar items and then extrapolated the error rate of the universe to estimate that Air Force inventory was overstated by \$1.5 billion and understated by \$.8 billion. That extrapolation is only valid if the sample is a true random sample. It also assumes that the errors found by the GAO will not be corrected before the time of a buy. In fact, location reconciliation, breach counts, routine inventories, etc., will correct many of those errors before the items are purchased.

[Text omitted.]

- o **FINDING O: Inaccurate Accounting in the Stock Fund: Excess and Obsolete Inventory Items Resulted in Losses.** The GAO concluded that an important factor in Systems Support Division operating losses and resulting surcharge increases is large quantities of excess and obsolete stock fund inventories at the Air Logistics Centers. The GAO analyzed inventory balances for the base support stock record account, which reflects over 95 percent of all Systems Support Division retail activity. The GAO found extremely large inventories relative to sales.

The GAO pointed out that one result of high inventory levels is increased operating costs and surcharge rates. The GAO noted that appropriations have been invested for years in stock that cannot be sold or is seldom needed by customers. The GAO observed that, during that period of time, Systems Support Division had to pay for the cost of

See comment 5.

storing and handling the extra items. The GAO asserted that, to control such operating costs, the Air Force Logistics Command must identify and dispose of those inventories no longer needed. The GAO noted that the Air Force Logistics Command has a program to dispose of excess and obsolete inventories--which caused the Systems Support Division to account for a FY 1989 loss from disposal of over \$146 million. According to the GAO, that loss was equivalent to about 16 percent of the FY 1989 sales to customers and was a major cause of the need to add \$180 million to the cost of the Systems Support Division items in FY 1990.

DOD RESPONSE: Partially concur. The Department disagrees with the GAO statement "Systems Support Division had to pay for the cost of storing and handling extra items." The cost of handling and storing items was an operation and maintenance expense. However, beginning in FY 1991, handling and storage became costs associated with the Cost of Operations Division of the Air Force Stock Fund. Beginning in FY 1992, costs associated with handling and storage will indirectly become part of the Air Force Stock Fund surcharges. In addition, the main driver of the increased Systems Support Division surcharge from FY 1989 to FY 1990 was price stabilization, not inventory losses. Inventory losses, as a percent of the surcharge, remained constant; however, price stabilization increased by 5.63 percent from FY 1989 to FY 1990.

[Text omitted.]

- o **FINDING S: Inaccurate Accounting in the Stock Fund: Tests Showed Major Errors in System Support Division Trial Balance Reports--Surcharges Have Increased Sharply.** The GAO observed that, in the past three years, the Air Force Logistics Command sharply increased the surcharge added to the cost of goods sold to Systems Support Division, Air Force Stock Fund, customers from about 13 percent in FY 1987 to over 20 percent in FY 1989. It is the position of the GAO that those sharp increases in Systems Support Division, Air Force Stock Fund, prices were largely caused by (1) the failure of the Air Force to properly bill for all Systems Support Division, Air Force Stock Fund sales transactions and (2) the need of the Air Force to dispose of excessive and obsolete inventories. The GAO explained that higher surcharge rates increase costs to the Air Force and other DoD customers. The GAO reported that the costs associated with inefficiencies, waste, and mismanagement are passed along to the customers with the normal costs of operations. According to the GAO, the appropriations may

have to be increased to enable Air Force Stock Fund customers to purchase needed items from Systems Support Division, Air Force Stock Fund.

The GAO observed that Air Force policy requires that new surcharge rates be set at the beginning of each fiscal year and not changed until the following year. The GAO reported that the Air Force Logistics Command uses Air Logistics Center trial balance data to consider the following factors to arrive at an overall surcharge rate:

- Inventory Expenses: Inventory Expenses include factors for net gains and losses from physical inventory adjustments; losses resulting from inventory shrinkage, theft, deterioration, damage, contamination, defects, and obsolescence; and adjustments to reconcile internal records.
- Price Stabilization: Price Stabilization includes factors for inflation or deflation of suppliers' prices, refunds made to customers, and maintenance of required cash balances with Treasury.
- Transportation: Transportation covers the cost of shipping material to customers, both within the United States and overseas.
- Inventory Maintenance: Inventory Maintenance finances the acquisition of inventories required to maintain item quantities at the currently approved stock level.

The GAO reported that, according to Air Force Logistics Command officials responsible for stock fund accounting and surcharge calculations in FY 1989, inventory expenses and price stabilization were the components primarily responsible for increases in Systems Support Division, Air Force Stock Fund, surcharge rates.

DoD RESPONSE: Nonconcur. The GAO statement "that the costs associated with the inefficiencies, waste, and mismanagement are passed along to the customers along with the normal costs of operation" misconstrues the purpose of the obsolescence/loss surcharge. The surcharge covers legitimate expenses associated with doing business. Covered are inventory adjustments; losses resulting from inventory shrinkage, theft, deterioration, damage, contamination, defects and obsolescence; and adjustments to reconcile internal records. They are all categories of expense that would be covered in prices to customers in private business. The main portion of inventory obsolescence/losses surcharge pertains to disposal of inventory. Inventory becomes excess due to changes in

See comment 7.

programs, increased reliability, and changes in items reparability, recoverability, as well as other factors that result in changes to requirements. Since items are procured based on a moving average of the latest two years of demand history and since average procurement leadtimes are greater than one year, items are particularly vulnerable to changes in program and other factors contributing to obsolescence.

[Text omitted.]

- o FINDING U: Inaccurate Accounting in the Stock Fund: Tests Showed Major Errors in System Support Division Trial Balance Reports--Inconsistent Collection Practices Produced Misleading Cash Balances. The GAO found that the Systems Support Division cash levels reported during FY 1989 were unreliable because of inconsistent processing of stock fund collections. The GAO explained that, because of changes in billing practices, data on collections reported from period to period was not comparable and the cash balance reported at fiscal year-end did not reflect the proper year end amount accurately. The GAO found about \$44 million of September 1989 bills were not processed until October 1989, resulting in a year-end cash balance that was lower than it would have been under normal processing. The GAO pointed out that, because reported cash balances were unnecessarily low due to inconsistent billing practices, the effectiveness of management decisions may have been undermined.

DoD RESPONSE: Partially concur. Whether the effectiveness of management decisions was actually undermined by inconsistent billing practices is questionable. Inconsistent practices did occur contrary to billing requirements stated in Air Force Regulation 170-25, Procedures in Support of Air Force Stock Fund. Conformance with directive billing requirements is now strictly monitored by the Air Force Logistics Command.

[Text omitted.]

CHAPTER 5: INTERNAL ACCOUNTING CONTROLS NOT ADEQUATE

[Text omitted.]

- o FINDING G: Air Force Federal Managers' Financial Integrity

See comment 8.

Act Reports Did Not Include Material Internal Control Weaknesses. The GAO observed that the Federal Managers' Financial Integrity Act was enacted in September 1982 to strengthen internal control and accounting systems throughout the Federal Government and to help reduce fraud, waste, abuse, and misappropriation of Federal funds. The GAO explained that the Act (1) holds agency managers accountable for correcting noted deficiencies and (2) requires that agencies annually identify and report internal control and accounting system problems and planned remedies. The GAO concluded that, based on its audit, and the audit of the Air Force Audit Agency, the Air Force is not reporting adequately material internal control weaknesses, as required by the Federal Managers' Financial Integrity Act.

The GAO pointed out that the Air Force, pursuant to the Federal Managers' Financial Integrity Act, reported to the Secretary of Defense for FY 1988, FY 1989, and FY 1990, that the system of internal accounting and administrative control in effect during those years, taken as a whole, complied with the requirement to provide reasonable assurance that costs were in compliance with applicable law; assets were safeguarded against waste, loss, unauthorized use, or misappropriation; and revenues and expenditures were properly accounted for and recorded to permit the preparation of accounts and reliable financial and statistical reports.

The GAO pointed out, however, that its audit of the Air Force financial management systems in effect during FY 1989 identified significant material internal control weaknesses, as previously discussed. The GAO concluded, therefore, that the Air Force internal controls and accounting systems were not sufficient to provide adequate and reliable financial information for effective management.

According to the GAO, the Air Force FY 1988, FY 1989, and FY 1990 reports did not recognize the following problems as material control weaknesses:

- unsupported and arbitrary adjustments made to account balances and records totaling billions of dollars;
- abnormal and unusual balances not being investigated and resolved; and
- control accounts not being reconciled with subsidiary accounts and records.

The GAO reported that, according to a Defense Accounting

and Finance Service, Denver Center official, the internal control weaknesses presented in the GAO report were considered for the FY 1990 Federal Managers' Financial Integrity Act report--but, [reportedly], because of time constraints, the Air Force did not conduct additional reviews to evaluate the significance of the weaknesses and, thus, they were not included in the FY 1990 Federal Managers' Financial Integrity Act report. The GAO noted, however, that in commenting on a draft of the May 1991 report (OSD Case 8376-I), the Comptroller, DoD, stated that the Air Force reviewed the cited deficiencies, found them not to be material, and did not include them in the FY 1990 Federal Managers' Financial Integrity Act report.

The GAO asserted it is difficult to understand how the Air Force could conclude that the deficiencies were not material. The GAO pointed out that, for purposes of Federal Managers' Financial Integrity Act, the Office of Management and Budget has defined a material weakness as "a situation in which the designed procedures or degree of operational compliance therewith does not provide reasonable assurance that the objectives of internal control specified in the [Federal Managers' Financial Integrity] Act are being accomplished." In the GAO view, the internal control weaknesses discussed in the current and previous reports preclude the Air Force from having reasonable assurance that internal accounting control objectives are being met. The GAO expressed the opinion that the cited weaknesses more than meet the Office of Management and Budget definition of material weaknesses.

The GAO observed that the Air Force Audit Agency also reviewed the Air Force implementation of Federal Managers' Financial Integrity Act for FY 1988 and FY 1989, and raised serious concerns about the validity of the Air Force assertions. According to the GAO, in 1988, the Air Force Audit Agency reported that the accounting system review program did not provide management an adequate basis for determining whether Air Force accounting systems were in conformance with appropriate accounting principles and standards. The GAO noted that, according to the audit agency, the major problem was the system managers were not implementing established procedures effectively.

The GAO also discussed the Air Force Audit Agency FY 1989 review, which raised concerns that there was a lack of assurance that internal control reviews performed by managers were sufficient to ensure the adequacy of controls and safeguarding of assets. The GAO reported that the Air Force Audit Agency noted that 22 of the 23 material internal control weaknesses addressed in the FY 1989 report were identified by sources external to the affected

organizations, with 19 of those weaknesses in areas that management had rated "low risk."

DoD RESPONSE: Nonconcur. The audit report raises issues regarding Air Force Federal Managers' Financial Integrity Act reporting. The Air Force programs for identifying material weaknesses in internal controls and nonconformances with Federal accounting requirements for the Federal Managers' Financial Integrity Act reporting were designed to meet the requirements of the law and of the Office of Management and Budget. In cases of determining whether internal control weaknesses are material for reporting, the decisions are the responsibility of Air Force management, which makes the determinations based on the factual data available at the time. For the FY 1990 Federal Managers' Financial Integrity Act reports, the internal control weaknesses identified in the FY 1989 GAO audit report were considered, but the extent of the weaknesses was not established factually. Several of the weaknesses cited in the audit report were at locations known to have accounting operational problems, and those sites were not considered necessarily to be representative of all the approximately 130 accounting and finance offices controlling and accounting for Air Force funds. Accordingly, the statements in the audit report regarding reporting of seeming material weaknesses in internal controls are true, but are not contradictory--as characterized in the report. The weaknesses were considered for reporting as material in FY 1990, but were not reported because their materiality could not be established. As part of the FY 1991 program of reviewing internal controls, the weaknesses identified in the audit report were included specifically and determinations of materiality will be made based on the results of the program. With regard to the program for identifying Air Force nonconformances with accounting requirements, actions were taken to correct the deficiencies the Air Force Audit Agency identified in FY 1988 through implementation of new standardized procedures for reviewing accounting systems. For FY 1989, the Air Force Audit Agency had only two minor concerns with reviews of Air Force systems for identifying and reporting possible systems nonconformances. Assistance was obtained from GAO and the Air Force Audit Agency in redefining the inventory of Air Force accounting systems for the FY 1990 reviews. In addition, the Air Force reported the General Accounting and Finance System as a noncompliant accounting system in Section 4 of its Federal Managers' Financial Integrity Act report.

[Text omitted.]

See comment 9.

CHAPTER 6: SHORT-TERM ACTIONS NEEDED TO IMPROVE QUALITY OF
FINANCIAL DATA AND ENSURE SUCCESSFUL COMPLETION OF
FINANCIAL STATEMENT AUDIT

- o FINDING A: Financial Improvement Strategies Need More Emphasis on Short-Range Objectives: Limited Progress Made In Implementing Corrective Actions. The GAO pointed out that its February 1990 report (OSD Case 8193-A) made 26 recommendations for improving the Air Force financial systems, internal controls, and accounting and financial information. The GAO noted that the Air Force provided an August 1990 action plan that addressed, either directly or indirectly, most of the recommendations. The GAO noted that the Air Force plan focused on interim "fixes" to many of the reported problems, until permanent solutions are instituted as a result of Defense Management Report initiatives, primarily the Corporate Information Management initiative. The GAO referenced a May 1991 report (OSD Case 8376-I) which provided the status of the Air Force interim actions. The GAO found that the Air Force had made only limited progress in addressing the deficiencies previously reported.

According to the GAO, the May 1991 report noted that as of January 1991, many of the Air Force interim actions were behind schedule. The GAO concluded that the Air Force has not placed sufficient emphasis on correcting the identified deficiencies. The GAO explained that, although the DoD envisions that the Corporate Information Management initiative will resolve many of the reported problems, those initiatives will not be completed for years. The GAO asserted that, in the meantime, there is a critical need now for good internal controls and reasonably accurate financial information. The GAO indicated that the Air Force and the Defense Finance and Accounting Service, Denver Center, still need to aggressively pursue efforts to make short-term improvements in internal controls and the quality of financial data in existing systems. According to the GAO, many of the problems can be resolved readily, with more stringent compliance with existing Air Force procedures and policies. The GAO emphasized that, absent such action, the Air Force may not be able to produce auditable financial statements for FY 1992--as was the case in 1988. The GAO stressed as equally important, until meaningful corrective actions are accomplished, effective management of Air Force activities and resources may be impaired.

The GAO observed that the DoD started the Corporate Information Management in October 1989. The GAO reported

that the Corporate Information Management objectives include (1) implementing new or improved business methods through the use of modern automated systems and creating more uniform practices for common functions and (2) improving the standardization, quality, and consistency of data from the DoD multiple automated information systems. The GAO further reported that the Corporate Information Management initiative is intended to eliminate or reduce duplicate systems that perform the same functions. The GAO stated that, in light of the long-established business practices of the DoD and hundreds of existing information systems supporting those practices, accomplishing the Corporate Information Management long-term goals will require many years--perhaps a decade. The GAO concluded, therefore, that satisfying the DoD financial information needs necessitates both a near-term and a long-term implementation strategy.

The GAO noted its recent audit work has shown that the DoD has encountered difficulties in the early stage of the Corporate Information Management initiative. According to the GAO, organizational stability was lacking--including problems with establishing organizational responsibility for the project and developing a strategy for systems standardization.

DOD RESPONSE: Partially concur. The DoD agrees that the Corporate Information Initiative is long term and, therefore, both near term and long term strategies are needed. The DoD does not, however, agree with the implication that there has been little short term effort. Considerable progress has been made in improving Air Force general ledger accounting. Many of the deficiencies cited in the GAO reports on Air Force financial accounting were attributed to noncompliance with or lack of understanding of existing requirements. The accounting and finance network was notified of the problems identified in the GAO reports and directed to enforce compliance with requirements. Applicable directives and instructions were reviewed and revised, where necessary, to clarify requirements. Explanatory articles were also provided to reinforce requirements in certain areas. Training received a major emphasis with the development of a self-study training package on base-level general ledger accounting. Formal training on general ledger accounting was increased in accounting and finance technical courses, and workshops also have been conducted to identify and address operational problems at accounting and finance offices. More emphasis has been placed on general ledger operations in the program to review Air Force internal controls and report material weaknesses. Improvements to improve the accuracy and reliability of Air Force accounting

See comment 10.

information also have been completed or are underway. In addition, procedures were implemented to provide accountability of satellite assets and aircraft engines at contractors. Improvements are currently underway to improve valuations for weapons systems. Other short-range improvements will be implemented, where possible, without costly systems developments. As for long range plans, it should be noted that the Air Force action plans have been transferred to Defense Finance and Accounting Service for completion. The Air Force is no longer responsible for the long range actions.

[Text omitted.]

The following are GAO's comments on the Department of Defense letter dated October 31, 1991.

GAO Comments

1. DOD's comments on a draft of this report contained 66 pages. Generally, DOD concurred with our findings and recommendations. We have included only those comments in which DOD did not fully concur with our findings or recommendations. The full text of DOD's comments are available from us by contacting Gerald W. Thomas, Assistant Director, at (202) 275-8841.
2. We have modified the report to indicate that the general funds general ledger is a subsystem of the General Accounting and Finance System.
3. The DOD response is discussed in the "Agency Comments and Our Evaluation" section at the end of chapter 2.
4. The DOD response is discussed in the "Agency Comments and Our Evaluation" section at the end of chapter 3.
5. The DOD response is discussed in the "Agency Comments and Our Evaluation" section at the end of chapter 4.
6. Our report states that the Air Force has to pay the cost of storing, safeguarding, and handling extra inventory items. Prior to fiscal year 1991, such costs were funded by operation and maintenance appropriations. These costs are now funded by the stock fund. Regardless of whether the costs are funded by the stock fund or operation and maintenance appropriations, the costs are ultimately borne by the United States taxpayer.
7. The DOD response is discussed in the "Agency Comments and Our Evaluation" section at the end of chapter 4.
8. The statement regarding the effectiveness of management decisions being undermined as a result of inconsistent billing practices is not in this report. That statement was included in an earlier report issued during this assignment entitled, Financial Audit: Financial Reporting and Internal Controls at the Air Logistics Centers (GAO/AFMD-91-34, April 5, 1991). In its comments on that report dated September 10, 1991, DOD did not take exception to the statement.

**Appendix IV
Excerpts From the Department of
Defense's Comments**

9. The DOD response is discussed in the "Agency Comments and Our Evaluation" section at the end of chapter 5.

10. The DOD response is discussed in the "Agency Comments and Our Evaluation" section at the end of chapter 6.